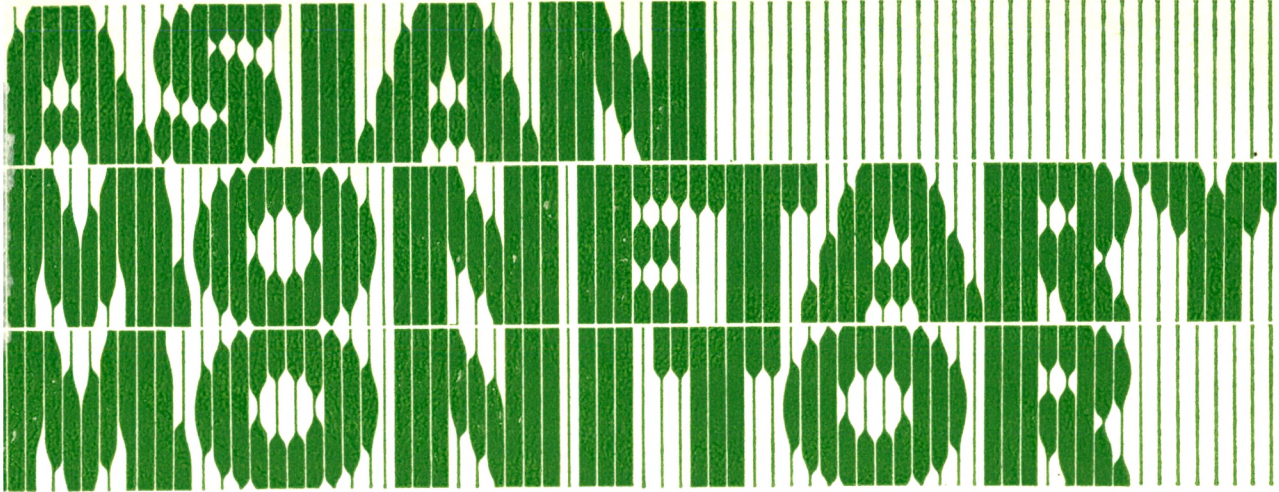




CONTENTS

Page

REGIONAL SURVEY:

Can Monetary Economics Explain Stock Market Behaviour?

JAPAN:

How Long till the Next Business Upturn?

THAILAND:

Domestic Policy Undermines the Baht.

1

EXCHANGE RATE FORECASTS:

Australian Dollar, Hong Kong Dollar, Japanese Yen & Singapore Dollar

2

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CONTENTS

	Page
REGIONAL SURVEY : Can Monetary Economics Explain Stock Market Behaviour?	2
JAPAN : How Long till the Next Business Upturn?	6
THAILAND : Domestic Policy Undermines the Baht.	18
EXCHANGE RATE FORECASTS	
Australian Dollar	24
Hong Kong Dollar	26
Japanese Yen	28
Singapore Dollar	30
AN INDEX OF AMM ARTICLES PUBLISHED IN VOLUME 4.	32

KEY TO SYMBOLS USED IN THE CHARTS

% RP - Percentage Rate of change over Preceding period.

% RS - Percentage Rate of change over Same period of
preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

REGIONAL SURVEY

CAN MONETARY ECONOMICS EXPLAIN STOCK MARKET BEHAVIOUR ?

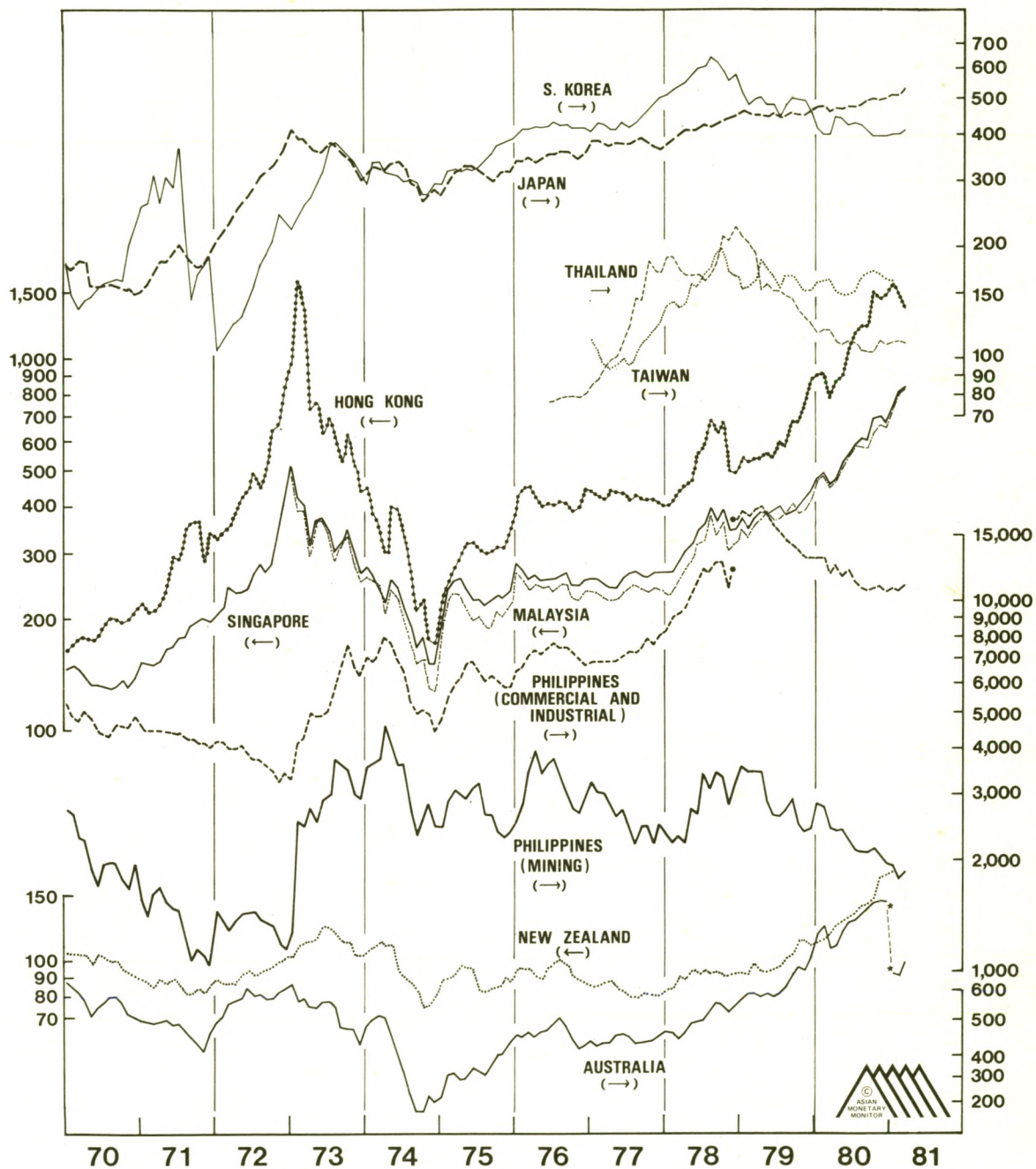
1980 was an outstandingly good year for investment in the larger stock markets of the East Asia Pacific rim, but a poor year for investment in the smaller markets. Whereas the major stock market indices for Japan, Hong Kong, Singapore, Malaysia, Australia and New Zealand all showed substantial increases, stock markets in Taiwan, S. Korea and Thailand all remained dull and flat for much of the year while the Philippines suffered a persistent downtrend.

What explains the difference in performance? Clearly it is not simply the different composition of exports in each country because otherwise, other things being equal, Philippine mining companies would have done as well as Australian mining companies whereas in fact they moved in markedly different directions over the year as a whole. Monetary theory suggests one possible explanation for the short term divergence of performance. In the longer term, however, economic theory suggests that there ought to be a relationship between economic performance and stock market performance so that economies like Korea and Taiwan which are growing very rapidly ought to have a good stock market performance in the long term, despite their poor performance over the past couple of years. Experience in the Far East provides a good test of these two ideas.

The relatively poor experience of stock markets in the smaller economies in 1980 is essentially a continuation of the slump which followed their generally buoyant performances in 1977-78. Each of the four smaller economies has an exchange rate which has been pegged more or less rigidly to the US dollar, and credit conditions in these economies have accordingly followed fairly closely the ups and downs of American interest rates. The associated uncertainties and the spillover effects of the US recession in early 1980 have undoubtedly contributed to the unfavourable stock market results. The poor performance of these markets is therefore a largely cyclical phenomenon, and one would expect to see these markets recover once conditions in the US credit markets and worldwide economic activity show a permanent and sustainable improvement.

By contrast, the economies where stock market performance in 1980 was good generally share a notable common characteristic - namely, that their exchange rates are not pegged rigidly to the US dollar, and therefore to a greater or lesser degree their monetary policies and conditions in their credit markets have been independent of developments in the USA. The clearest case is Japan where the stock market index (in yen terms) has been rising in an exceptionally stable manner ever since 1975 i.e. soon after monetarist policies were adopted. Fluctuations in the ¥/\$ rate have meant that in US dollar terms stock market returns have been somewhat variable, but for domestic investors investing in the Japanese stock exchange has generally been more consistently rewarding than in the days of the pegged ¥/\$ exchange rate.

CHART 1 FAR EAST STOCK PRICE INDICES

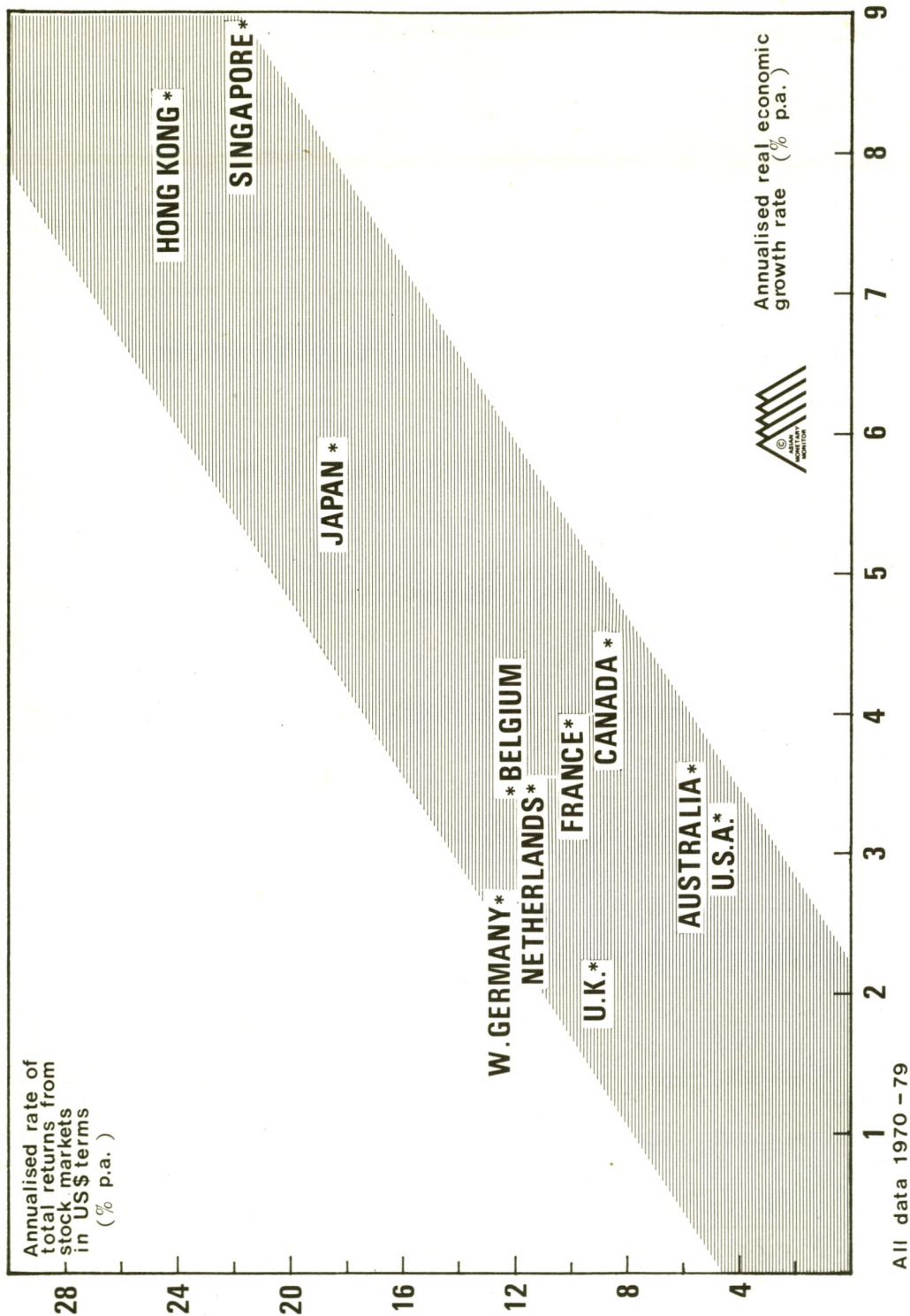


• Change of basis of compilation on 4/12/78

• Change from Sydney All Ordinaries to Australian All Ordinaries Index

CHART 2

RELATION BETWEEN ECONOMIC GROWTH AND STOCK MARKET TOTAL RETURNS



Hong Kong has enjoyed a stock market boom against the background of rapid domestic monetary growth, strong economic growth and a buoyant property market. Here again the exchange rate has been allowed to float. This fact, as explained in past issues of AMM, has meant that monetary growth is no longer subject to the automatic corrective mechanism of changes in the balance of payments. Singapore and Malaysia have also enjoyed boom conditions very similar to Hong Kong, the only differences being that Malaysia has had the added bonus of becoming a substantial oil-exporter in recent years, but again both countries have a managed exchange rate regime independent of the US dollar which has contributed to interest rates and credit conditions that have supported a stock market boom. Australia, like Malaysia, has been a beneficiary of the rising price of energy, but it too has operated a deliberate managed exchange rate system which has to a significant extent insulated Australian financial markets from conditions elsewhere.

In short, it can be argued that in the past year or two those countries which have allowed their exchange rates to fluctuate against the US dollar (or which have managed their exchange rates against a basket of currencies) have had a better stock market experience than those countries which have kept their currencies pegged to the US dollar. This is not to say that the situation will not change when US interest rates come down, or that those countries which have floated (or managed) their currencies have done a uniformly good job in managing their money supplies, but the basic facts are consistent with monetarist predictions of the effects of operating pegged versus floating exchange rate systems.

In the longer term one would expect countries which grow rapidly to enjoy better stock market performance than countries which grow slowly. In Europe and North America the close clustering of economic growth rates in the range 2-4% p.a. makes it extremely difficult to separate cyclical factors affecting the stock markets from longer term factors such as savings rates, productivity growth rates, and the degree of government intervention. However, if one compares economies of the Far East with economies of Europe and North America, ranking them by economic growth rate and by the total rate of return from stock market investment, the results (shown in Chart 2) are very striking. Common sense would lead one to think that economies which grow rapidly must be comprised of rapidly growing companies, and many of these companies in turn would feature in the stock market indices. Stock market performance should therefore reflect the growth and success of these companies, which is exactly what Chart 2 demonstrates.

In short, extending one's horizon from Europe and N. America to include data from the Far East enables one to say that stock market performance in the long term does indeed appear to be related to economic performance. So despite some apparent contradictions in the short term, economics does offer a coherent explanation both for the shorter term divergence among Far Eastern markets, and for the longer term difference between stock market performance in the Far East and elsewhere.

JAPAN

HOW LONG TILL THE NEXT BUSINESS UPTURN ?

Despite the widespread attention that is being paid to reductions in Japan's official discount rate and despite official rhetoric about easing window guidance on bank loan increments, Japan's money supply is continuing to decelerate, at least on a year-to-year basis. This is true both for the narrower monetary aggregates M_1 and M_1' (which includes corporate fixed term deposits), and for the broader aggregates M_2 , M_2 +CDs, and M_3 . M_2 +CDs, for example, hit a peak of 12.8% in May 1979, and since then it has slowed continuously to 7.8% in December 1980. On a simple view this would suggest that the Japanese economy will continue to slow down over the next few months, and that any significant recovery must await an upturn in monetary growth. Since that upturn is not yet in evidence, the recovery may not occur until summer or even autumn.

This analysis is supported by an examination of the main credit counterparts of the money supply: short term net foreign assets, credit to the government sector and credit to the private sector. Since 1979 the contribution of net foreign assets has been persistently negative, and the contribution of credit to the public sector has fallen steadily, falling to just 1.2% in the final quarter of 1980. The main counterpart contributor, credit to the private sector, saw its contribution fall from 10% in early 1977 to 8.5% in the final quarter of 1980. It would appear from these figures that both public and private sector demand for credit are weak, and, taken in conjunction with the Bank of Japan's forecast for money growth (M_2 +CD's) of around 7% in the first quarter of 1981, some further deceleration of money growth could be in the pipeline.

Almost all the major Japanese forecasters, however, foresee stronger economic growth in Fiscal Year 1981 than in FY 1980. Their forecasts, shown in Table 2, range from 5.7% real growth expected by the National Economic Research Institute (compared with the 5.0% they foresaw for FY 1980), to 4.0% expected by the Sumitomo Bank (compared with the 3.8% they forecast for FY 1980). The only possible basis on which these forecasts could hold good and yet be consistent with the pattern of monetary growth is if the economy were to experience a weakening in the first two calendar quarters of 1981, followed by much stronger economic growth in the last two quarters of 1981 continuing into the first quarter of 1982. A weak first quarter in 1981 would lower the actual growth rate for FY 1980, a weak second quarter in 1981 could be consistent with the slower money growth in the first quarter of 1981, but stronger growth in the next three quarters would then be necessary to lift the average for the whole of FY 1981 above the real growth rate for FY 1980.

Before considering the likelihood of the consensus outcome it is worthwhile pausing to look more carefully at the behaviour of Japan's monetary aggregates. The Bank of Japan

TABLE 1

COMPARISON OF INITIAL FORECASTS WITH ACTUAL ECONOMIC PERFORMANCE

	(growth rate, % p.a.)							
	Real GNP		Final Domestic Demand		Private Corporate Investment		Exports	
	FY79	80	79	80	79	80	79	80
ACTUAL	6.1	4.8	5.0	2.0	13.0	5.1	14.2	18.4
Asahi Seimei	6.0	5.0	5.3	3.9	7.1	4.9	4.2	13.1
Kyoto University	5.2	3.7	4.7	3.2	7.5	1.3	0.5	14.5
Government	6.3	4.8	4.9	3.7	8.1	4.0	2.1	8.9
National Economic Research Institute	5.5	5.0	4.9	4.1	7.1	6.3	2.2	7.7
Sanwa Bank	4.8	3.5	4.4	2.7	4.4	1.8	1.7	10.1
New Japan Securities	5.1	3.7	5.0	3.0	4.8	4.4	1.0	8.8
Sumitomo Bank	4.3	3.8	4.1	3.3	4.6	2.3	2.0	7.9
Sumitomo Trust Bank	4.5	4.3	4.5	3.9	6.9	3.3	0.4	11.2
Daiwa Bank	5.0	3.6	4.9	3.0	6.0	3.7	1.3	8.1
Daiwa Securities	5.2	2.1	4.6	2.6	10.6	0.4	2.1	6.7
Nikkei Research	4.5	3.9	4.7	3.4	2.9	4.1	1.5	9.7
Nikkei Databank	5.0	3.7	4.7	3.4	5.8	3.2	1.9	9.4
Nikko Research Centre	5.5	3.8	4.9	3.0	7.9	3.6	3.0	7.2
Nomura Research Institute	4.8	2.9	5.1	3.2	3.5	1.9	2.0	8.1
Mitsubishi Trust Bank	5.0	4.5	4.5	4.1	4.7	4.7	0.7	7.0
Mitsubishi Research Institute	4.0	3.5	4.1	3.3	4.5	0.5	0.7	6.5
Yamaichi Research Institute	5.0	3.8	4.5	2.6	5.4	3.3	0.4	11.2

Notes 1. All data at 1970 prices.

2. Data for FY 1980 (Actual) is based on latest E.P.A. estimates (Dec. 20, 1980).

TABLE 2
ECONOMIC FORECASTS FOR FY 1981

	Nominal GNP	Real GNP	Final Domestic Demand	Private Corporate Investment	Exports	Imports	Index of Industrial Production	WPI	CPI
Government	9.1	5.3	4.9	7.3	8.2	3.7	5.3	4.1	5.5
National Econ. Res. Institute	9.9	5.7	5.1	8.2	6.9	3.0	7.4	1.9	4.7
Nikkei Research	9.3	5.1	4.5	6.4	6.3	3.1	5.0	3.0	4.7
Fuji Bank	9.1	4.8	4.7	6.0	7.8	3.9	5.1	3.9	5.5
Kyoto Univ.	9.4	4.7	5.0	4.2	6.4	2.7	3.9	3.1	5.0
Nikko Research	8.7	4.6	4.5	3.6	6.1	1.7	2.7	1.6	4.6
Mitsubishi Res. Inst.	8.9	4.5	4.1	6.0	7.7	2.7	4.2	3.2	5.5
Sanwa Bank	8.0	4.5	4.1	4.5	8.1	4.4	3.9	2.5	5.0
Keidanren	8.7	4.2	3.7	5.1	7.9	3.7	3.6	4.1	5.4
Yamaichi Res. Inst.	7.8	4.1	3.7	4.9	4.6	0.8	3.3	1.1	5.2
Nomura Res. Inst.	8.6	4.1	4.5	1.6	2.6	0.2	2.3	1.1	5.0
Sumitomo Bank	8.5	4.0	3.5	4.5	2.5	3.0	3.0	5.5	5.5

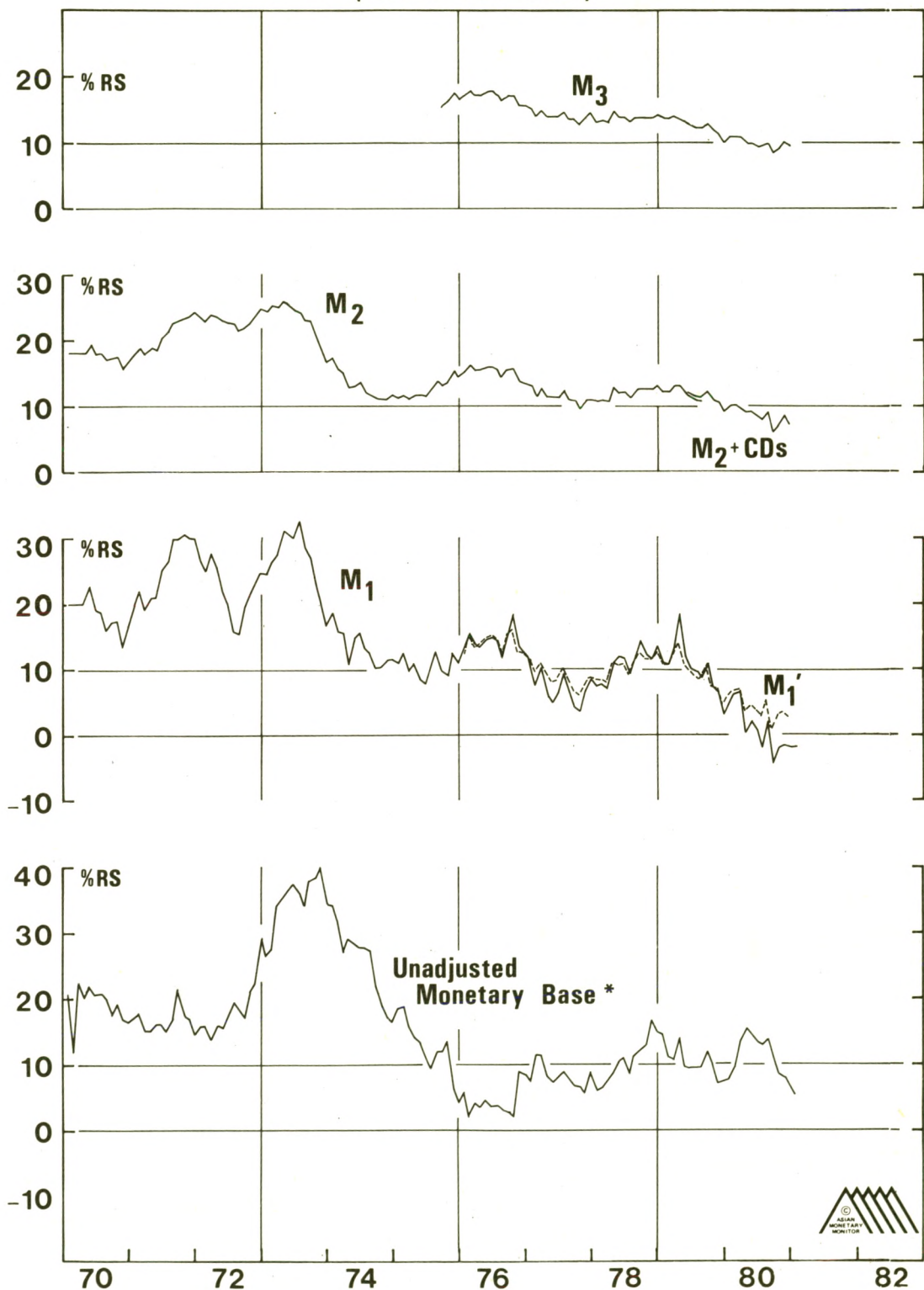
Note: Data in columns 2-7 are in real terms.

TABLE 3
MONETARY AGGREGATES PUBLISHED BY THE BANK OF JAPAN

	Month-end Series	Month-average Series	
	Year-to-year	year-to-year	month-to-month
A. Cash Currency held by public	✓	✓	n.a.
B. Cash held by banks	✓	n.a.	n.a.
C. Total bank reserves	✓	n.a.	n.a.
D. Monetary base	= (A+C)	n.a.	n.a.
E. M1	✓	✓	✓
F. M1'	✓	n.a.	n.a.
G. M1'+CDs	✓	n.a.	n.a.
H. M2	✓	✓	n.a.
I. M2+CDs	✓	✓	✓
J. M3	✓	n.a.	n.a.

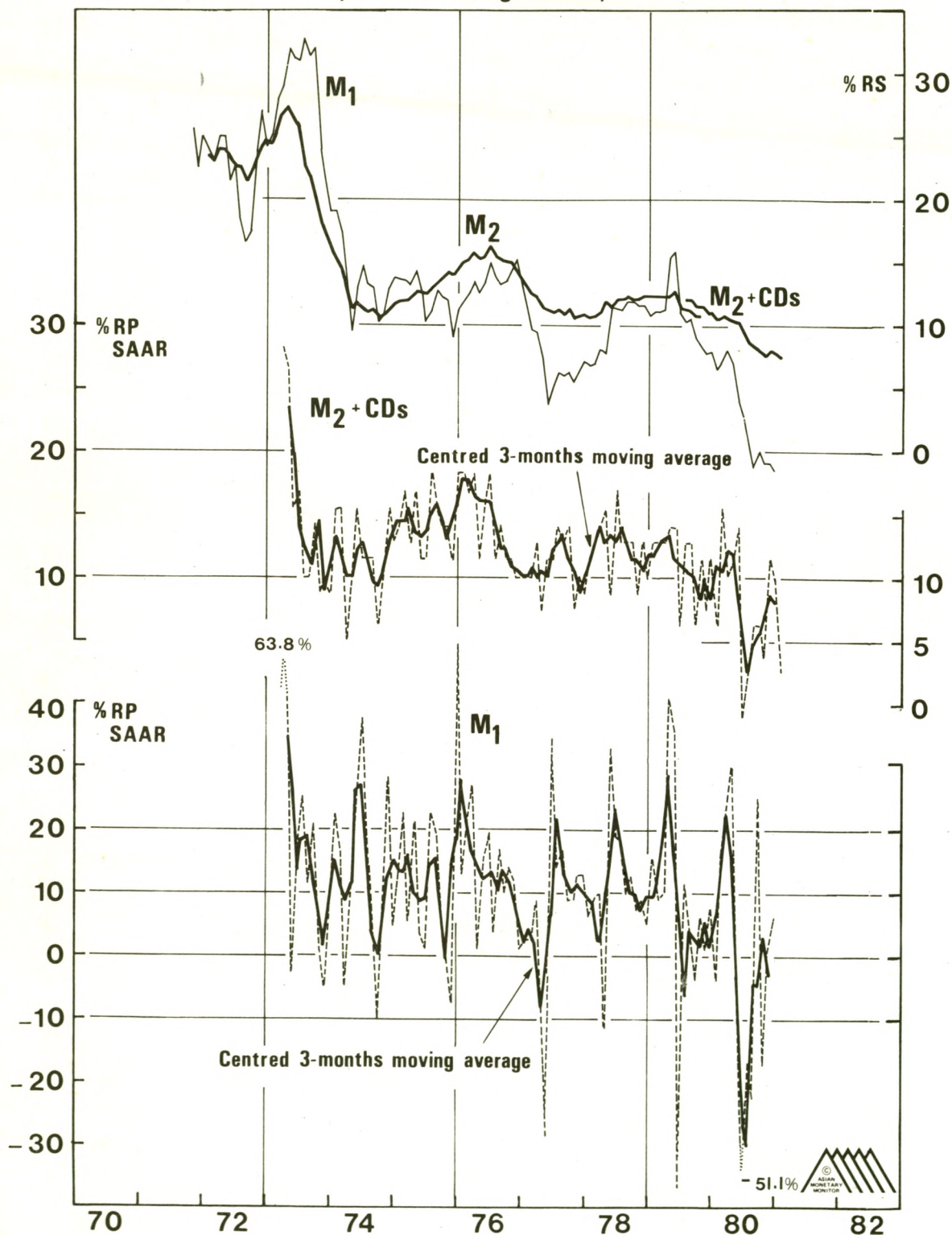
Note : n.a. = Not available.

JAPAN
CHART 1: GROWTH OF THE MONETARY AGGREGATES
 (month end data)



* Not adjusted for changes in reserve requirements

JAPAN
CHART 2 : GROWTH OF THE MONETARY AGGREGATES
 (month average data)



collects month-end data for nine different series (Table 3), from which a tenth series - the monetary base - can readily be calculated. Five of these month-end series are shown in Chart 1. The Bank of Japan also publishes month-average data for cash currency held by the non-bank public, M_1 , M_2 and M_2 +CDs. These latter four series are published as year-to-year rates of change, and, in addition, seasonally adjusted month-to-month series are released for M_1 and M_2 +CDs.

The Bank of Japan focuses on the year-to-year change in M_2 +CDs (month average basis) as its intermediate target for monetary policy. In other words it adjusts the monetary base through open market operations and loans to banks at the discount window in order to achieve a level of the base which is compatible with its desired M_2 +CD target. This aggregate is the one most discussed in Japan for policy purposes. It is also the best one to follow on a continuing basis because Bank of Japan staff have found from extensive empirical studies that this measure of money is a better indicator of private sector liquidity and hence a more reliable predictor of aggregate spending than the narrower M_1 series.

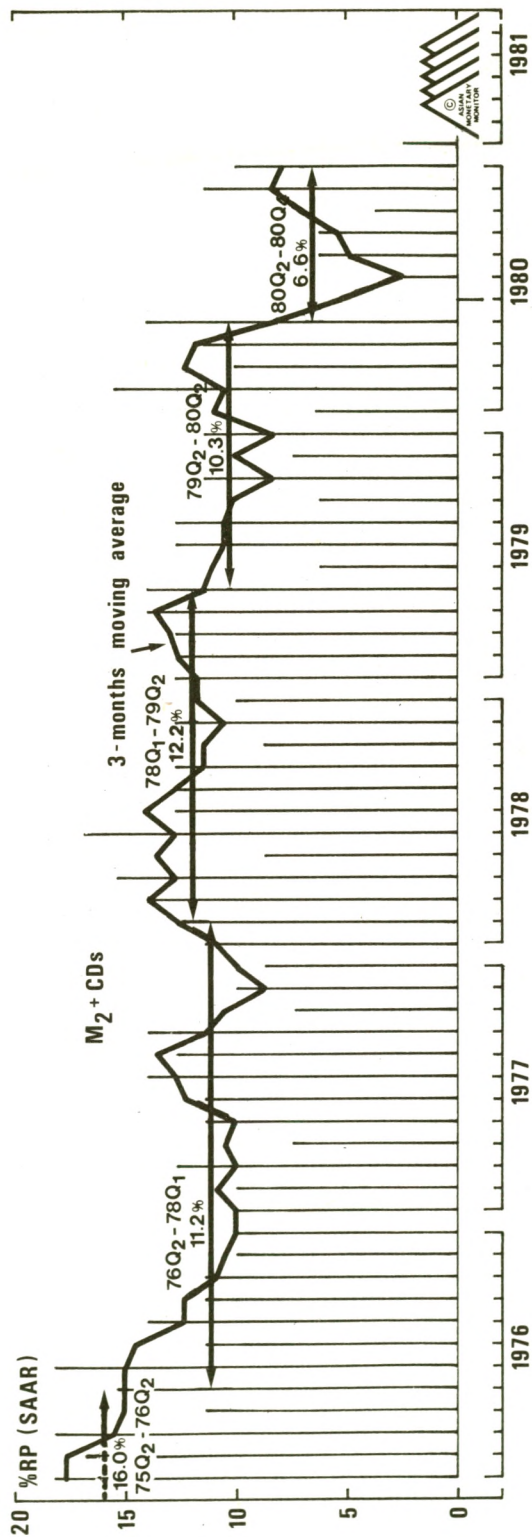
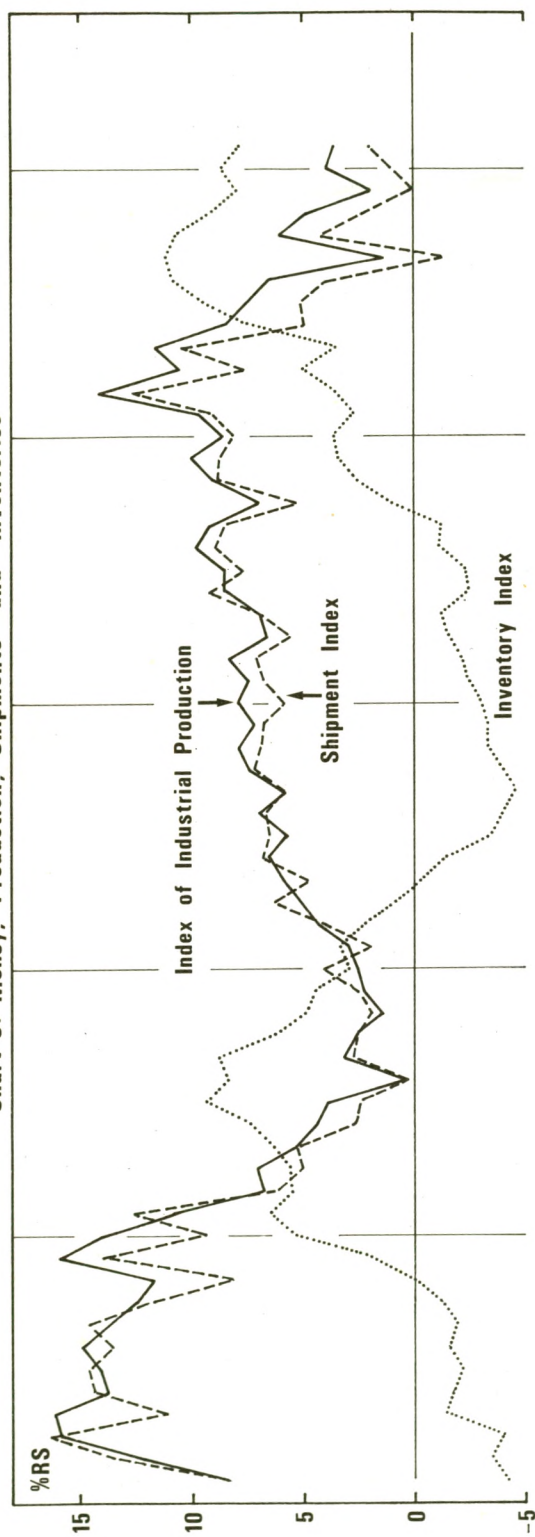
Apart from the United States, Japan is the only major OECD economy which compiles monetary data on the more dependable month-average basis. The available data for Japan are shown in Chart 2 in the form of year-to-year changes in the upper section, and in terms of seasonally adjusted annualised rates of change in the two lower sections. Because of the volatility of the month-to-month series a centred 3-month moving average is shown in order to convey the trend more clearly.

It is easy to see from the year-to-year month average series at the top of Chart 2 that there have been three occasions since 1972 when monetary growth has slowed decisively: in 1973-74, 1976-77 and from mid-1979 to the present time. These three episodes also show up in the seasonally adjusted series, though each period contains some sharp upward and downward spikes which obscure the picture slightly. The first steep downturn in 1973-74 produced the recession of 1974-75 which was also associated with the first oil crisis, and will not be discussed any further here. Our focus is on the much milder monetary slowdowns of 1976-77 and 1979-80. For, as can be seen in Chart 3, despite the mildness of these decelerations, each has been followed by a pronounced slowdown in the growth of industrial production and shipments, and each has also been followed by a sustained (and involuntary) build-up in inventories.

Assuming there is no further deceleration in money growth after the first quarter of 1981 there are two factors which suggest that an upturn in industrial output can be expected from the second or third quarter of 1981, but these are offset by one more factor which could delay the recovery until somewhat later.

First, although the year-to-year money figures continue to show a deceleration, the month-to-month figures reached a

JAPAN
Chart 3: Money, Production, Shipments and Inventories



trough last June and have been accelerating since then. Having climbed gradually in late 1979 and early 1980, the centred three month moving average of M_2 +CDs (seasonally adjusted, month average data) reached a peak of 12.3% in March 1980, and subsequently plunged to 2.5% in July. Since July there has been a steady upswing to 8.4% in November, with a minor setback in December to 7.9%. It is probable that money growth (M_2 +CDs) will now stabilise in the 7-9% range.

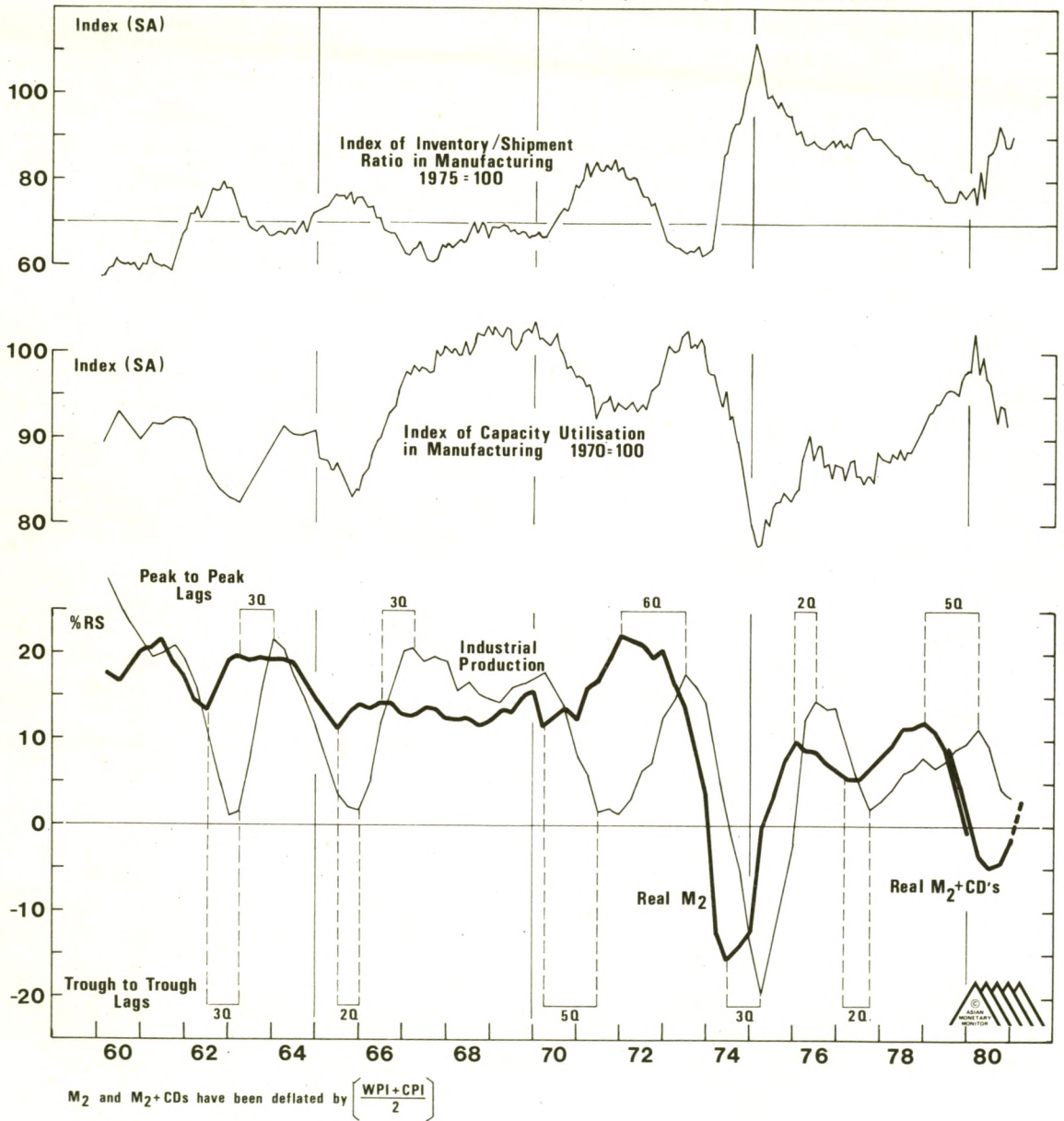
The downswing in money growth in 1980 needs to be put in a broader context. One of the factors behind the downswing in M_2 +CDs was the transfer of deposits from banks to the postal savings system. However, postal savings deposits are included in M_3 and, as Chart 1 shows, the growth of M_3 has been declining anyway, so that all of the monetary aggregates have been decelerating. Chart 3 relates shifts in the trend rate of growth of money to movements of the industrial production index. Allowing for a lag of several months between changes in the rate of money growth and their impact on industrial activity, the slide in industrial production in 1977 can be quite clearly related to the preceding slowdown in monetary growth from 16% between mid-1975 and mid-1976 to 11.2% in the period after mid-1976. The reason was that the monetary slowdown was not a purely temporary one. With minor variations it lasted for four years (i.e. from mid-1976 to mid-1980).

However, it is interesting to note that Japan's industrial recovery in 1978-79 did not require any deliberate monetary stimulus of the kind so often advocated by non-monetarists. The average rate of money growth of 12.2% p.a. from the first quarter of 1978 to the second quarter of 1979 was only one percentage point higher than the preceding step down to 11.2% and as such can hardly be described as a significant change in direction. Similarly, although it has been differentiated in our chart, the period from the second quarter of 1979 to the second quarter of 1980 ought to be regarded as an extension of the same trend of money growth. In essence monetary growth in Japan throughout the four years from the second quarter of 1976 to the second quarter of 1980 was stable in the range 10-12% p.a.

The initial downstep from 16% to 11.2% at first produced a mild recession in industrial activity, but continuation of money growth at a steady pace enabled the economy gradually to recover again so that by early 1980 industrial production was rising by 10% on a year-to-year basis. The final spurt in industrial activity in early 1980 was no doubt stimulated in part by the depreciation of the yen in the first quarter of 1980, but even allowing for that the sustained upswing from mid-1977 to early 1980 is good evidence that steady money growth can generate a healthy industrial recovery without artificial stimulus.

The downward step in money growth to 6.6% p.a. from the second quarter of 1980 appears to have had its impact on industrial activity much more quickly than the down-step in 1976-77. It seems probable that the appreciation of the yen from around ¥260 per US\$ to ¥220 by yearend was one factor

JAPAN : CHART 4
Real Money, Industrial Production, Capacity Utilisation and Inventories



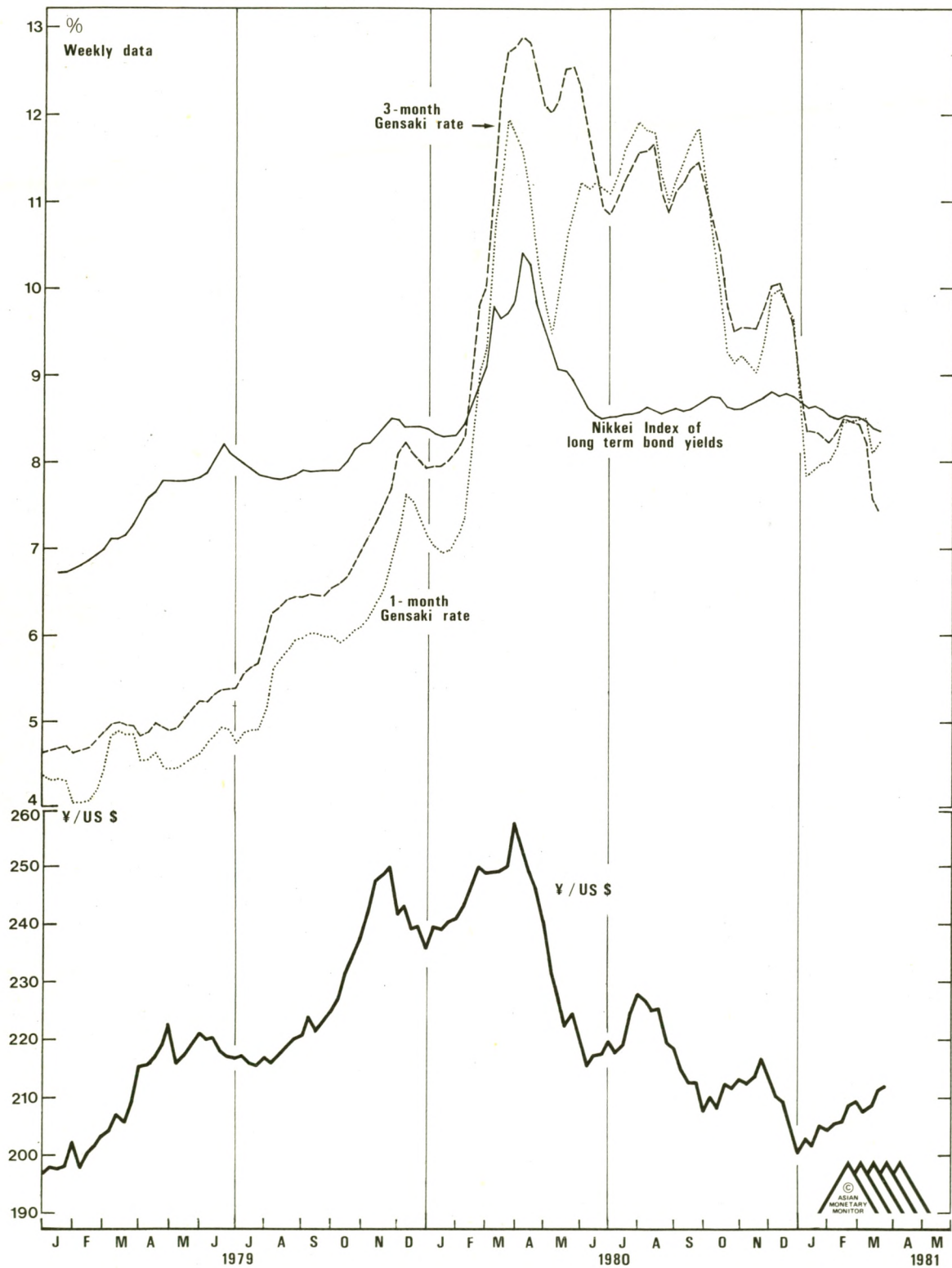
speeding up the transmission of the changed monetary growth rate, while the downturn in economic activity in the USA and Europe also played a part. Based on the experience of 1977-78, however, it should not be necessary for the Japanese authorities to resort to the printing press to bring about another sustained industrial recovery. Money growth in the 7-8% range ought to be quite compatible with an economic upturn later in 1981.

A second factor favouring an industrial upturn later this year is that not only have the nominal money supply figures begun to turn upwards, but the real money supply figures have also bottomed out and are now moving upwards (see Chart 4). In the first quarter of 1981 real money supply will show positive growth on a year-to-year basis for the first time in over a year. Chart 4 also records the length of the lags between peaks in real money and the peaks in industrial production, and the troughs in each series. In the period since 1960 the average lag between the peaks of real money and industrial production has been almost 4 quarters, while the average lag between troughs has been somewhat shorter - just 3 quarters on average. If the trough of real money growth is taken as the second quarter of 1980, this would suggest an upturn in industrial production starting around the first quarter of 1981, though if the lag was as long as it was in 1971 it might be five quarters or more before there was any significant upturn (i.e. the recovery would not come until the third quarter of 1981).

A third factor, however, is pointing towards a slower recovery than might otherwise have been hoped. In Chart 3 the year-to-year change in inventory levels of finished goods shows that at the beginning of 1981 inventories were up by some 7% over their levels in January 1980, which were in turn almost 5% above their levels in January 1979. Relative to shipments they were still at a high absolute level at the start of 1981 (see Chart 4). The ratio of inventory to shipments (1975=100) would need to decline some 15 points - from 90 in January to 75 - to reach the trough enjoyed in 1979, or as much as 20 points to reach the average levels experienced in the mid-1960s. The inventory shake-out is taking much longer than many commentators had originally expected and is delaying the possibility of an early recovery in industrial production.

FORECAST: Interest rates in Japan have been falling as demand for credit has weakened against a background of continuing deceleration in money growth and lower inflationary expectations. Lower inflation and stabilisation of monetary growth in combination suggest that real money supply and hence real purchasing power will be rising over the next few months. However, based on past records it would be premature to expect any significant recovery in the first calendar quarter of 1981, and the recovery might even be delayed until as late as the third quarter. This possibility would be heightened by disruptive external factors such as another downturn in U.S. economic activity, or another twist in the oil price spiral.

JAPAN : CHART 5
Short and Long Term Interest Rates and the ¥/US \$ Rate



Consumer spending has been sluggish and is unlikely to experience any sudden upturn, especially against a background of relatively poor corporate profits, a year of falling real wages, and spring wage hikes for 1981 in the 7-8% range.

The cautiousness of this outlook for the economy should not necessarily be interpreted as implying bearishness for financial markets. On the contrary, interest rates are likely to fall further in response to the weakness of domestic demand and any relaxation of monetary restraint. Chart 5 opposite shows that short term gensaki (repurchase) rates have begun to edge below long term bond yields for the first time for almost a year, so the yield curve is at last returning to being positively sloped. As long as the domestic economy remains weak the balance of payments is likely to remain strong, even in the face of "voluntary" export restraints. Therefore despite disappointment in industrial circles with the economy's current performance the bond market should be very firm while the easy liquidity situation should make for a buoyant equity market.

THAILAND

DOMESTIC POLICY UNDERMINES THE BAHT

In our most recent AMM article on the Thai economy (Vol. 4 No. 2) we outlined the uncomfortable options facing the country's economic authorities. At that time Thailand was faced with the prospect of a deteriorating current account deficit and rising inflation, both in absolute terms and relative to inflation in the US. The Thai monetary authorities appeared to have been alert to the dangers of an overheated economy and had successfully reduced monetary growth from 20% year-on-year at the beginning of 1978 to just below 15% by the fourth quarter of 1979. The choice they faced appeared straightforward: either they could continue with the monetary squeeze in order to bring domestic inflation more in line with that of the US, or they could simply devalue. The first alternative would have brought about a temporary, cyclical slowdown in economic activity, which would eventually have been "rewarded" by easier liquidity and a sustainable improvement in the external account. The second option although it would mitigate any recession, carried the risk of further domestic inflation undermining the competitive gains arising out of the devaluation.

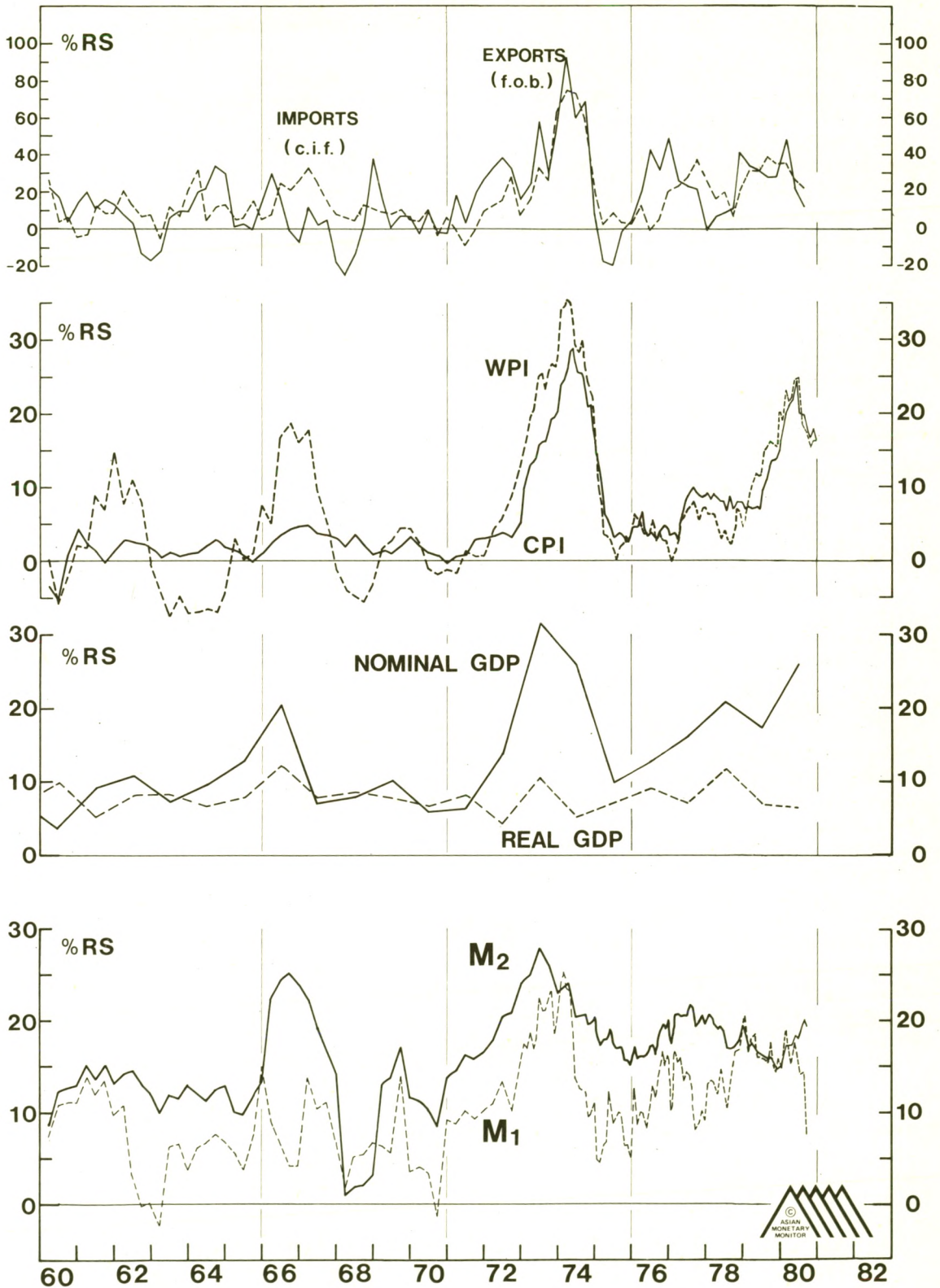
In the event, the Thai authorities have not pursued either of these basic options. Their decision is not a reflection of any fundamental improvement in the underlying state of the domestic economy.

During 1980 the continued high level of economic growth (around 6% in real terms) and a rapid rate of consumer price inflation (16.4% year-on-year in December, see Chart 1) in comparison to 6.9% in the first half of 1979) were reflected in a continuation of the decline in Thailand's balance of trade position. The trade deficit rose by around 20% to reach approximately Baht 45 billion, with exports decelerating sharply while imports did not slow down to the same extent (see Chart 1).

Nevertheless, the Thai authorities have been at pains to point out that the rise in the trade deficit is primarily the consequence of the increase in OPEC prices during 1979. There is some validity to their argument since non-oil imports rose by only slightly more than 10% in 1980, in comparison to a 90% surge in imported oil costs which now form 31% of total imports. Nevertheless the crucial question is how Thailand might cope with its much larger oil bill. Basically the rise in OPEC prices represents a transfer of real income away from oil importing countries such as Thailand. Without a corresponding increase in Thai export prices the rise in oil prices is a once and for all income loss that is revealed in the decline in Thailand's terms of trade. From the second quarter of 1979 to the first quarter of 1980 the Thai terms of trade plummeted by 11%. This was primarily due to a 24% rise in unit import prices. Without an increase in Thai export prices there is nothing that can be done to retrieve this income loss. However overall GNP growth can be maintained if economic resources are shifted away

THAILAND

CHART 1 : MONEY, OUTPUT, PRICES, AND TRADE



from domestic consumption (of goods either domestically produced, or imported) and transferred to the export sector.

In an economy where the exchange rate is pegged this is typically what would have occurred. A balance of payments deficit resulting either from a rise in import prices or from a domestic inflationary boom would usually lead to an external drain on the money supply and rising interest rates. Tighter liquidity would cause a medium term slowdown in the economy and reduced import demand. Slower monetary growth and a reduction in economic activity would also typically produce a cyclical fall in inflation, thereby stimulating export growth. This broadly was the pattern displayed during 1974 and 1975 in the aftermath of the first oil crisis. During that cycle the Thai authorities allowed their domestic economic policy to be dictated by the constraints of a weak external sector. It was a good example of the orthodox economic adjustment mechanism under a fixed exchange rate.

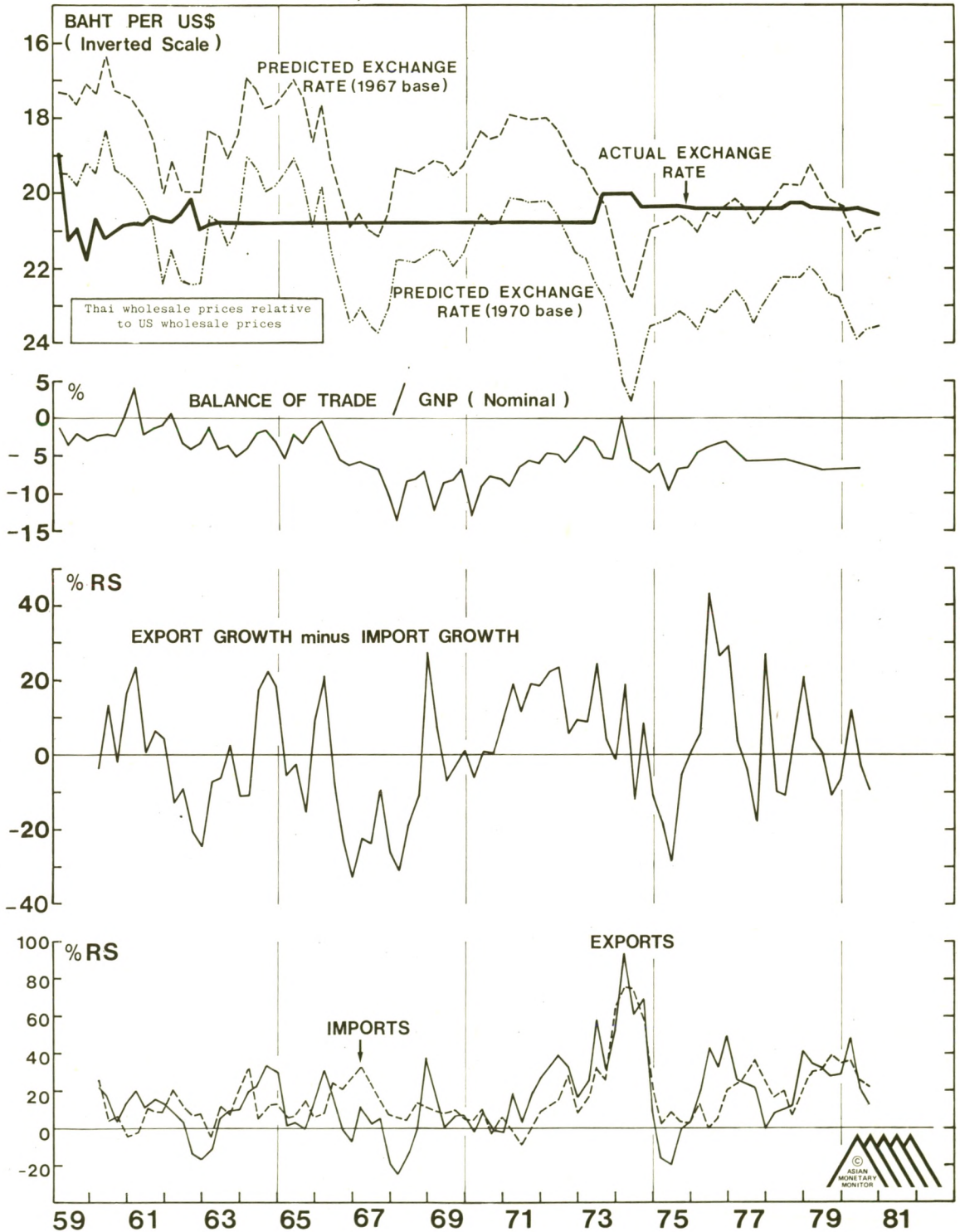
At present it seems that Thailand is attempting to do what in the longer term is not possible: the government is effectively trying to follow its domestic monetary and fiscal policies independently of the constraints (which sooner or later will become binding) inherent in an economy with a pegged exchange rate. In other words the Thai economic authorities have apparently tried to abandon the rules of the pegged exchange rate game.

In this cycle the Thai authorities have deliberately maintained a relatively high real growth rate despite a burgeoning trade and current account deficit. There have been two factors at the root of this attempt to pursue an independent domestic economic policy. First, until March 1980 domestic interest rates were maintained at artificially low levels. Thus in spite of a record current account deficit during 1979 liquidity remained relatively easy and monetary growth declined only slightly. Second, over the last three years Thailand has embarked on a programme of sizeable official and semi-official overseas borrowing. The government's total external debt and debt service obligations have risen by nearly 300% over the past year. As a result of these borrowings, the record trade and current account deficits of the last three years have not, in fact, led to major overall balance of payments deficits. Thus the decline in monetary growth which would typically accompany rising external deficits in a fixed exchange rate economy has not occurred. As a consequence of very large overseas borrowings in 1980 Thailand actually recorded a surplus of Baht 10 billion on the balance of payments (the current account deficit was Baht 60 billion) and this was probably an important factor behind the resurgence in monetary growth last year when M_2 growth accelerated from around 15% year-on-year at the end of 1979 to 18.5% in the fourth quarter of 1980.

Although Thailand's consumer price inflation rate has fallen sharply from its peak of 24.4% in May 1980 to 14% in February of this year, we can be confident that this performance will be relatively short-lived unless the Bank of Thailand follows a more restrictive monetary policy.

THAILAND

CHART 2: TRADE, RELATIVE PRICES AND EXCHANGE RATE



We may also be confident that if the Thai authorities continue with policies that promote relatively high real growth and continued upward pressure on the level of inflation, that there will be growing pressures for a depreciation of the Baht. The first indications of this are beginning to appear. The IMF has refused to allow the Thai government to draw down a third tranche of IMF loans unless the Baht is devalued by 10%. At the moment Thailand probably has a sufficient number of loans arranged but not yet drawn down to be able to avoid further IMF loans this year. Nevertheless the Thai authorities have compromised and apparently agreed to depreciate the Baht by about 1% every six months from the autumn of 1980 to the end of 1981.

At present international capital markets are still willing to lend to finance Thailand's current account deficit - although it is perhaps notable that Thailand's credit rating has slipped below that of the Philippines during the last year. However, the World Bank has projected that Thailand's debt service ratio could rise to 30% by 1985. Projections of this kind will make it steadily more difficult for Thailand to increase its overseas borrowings at a rapid rate.

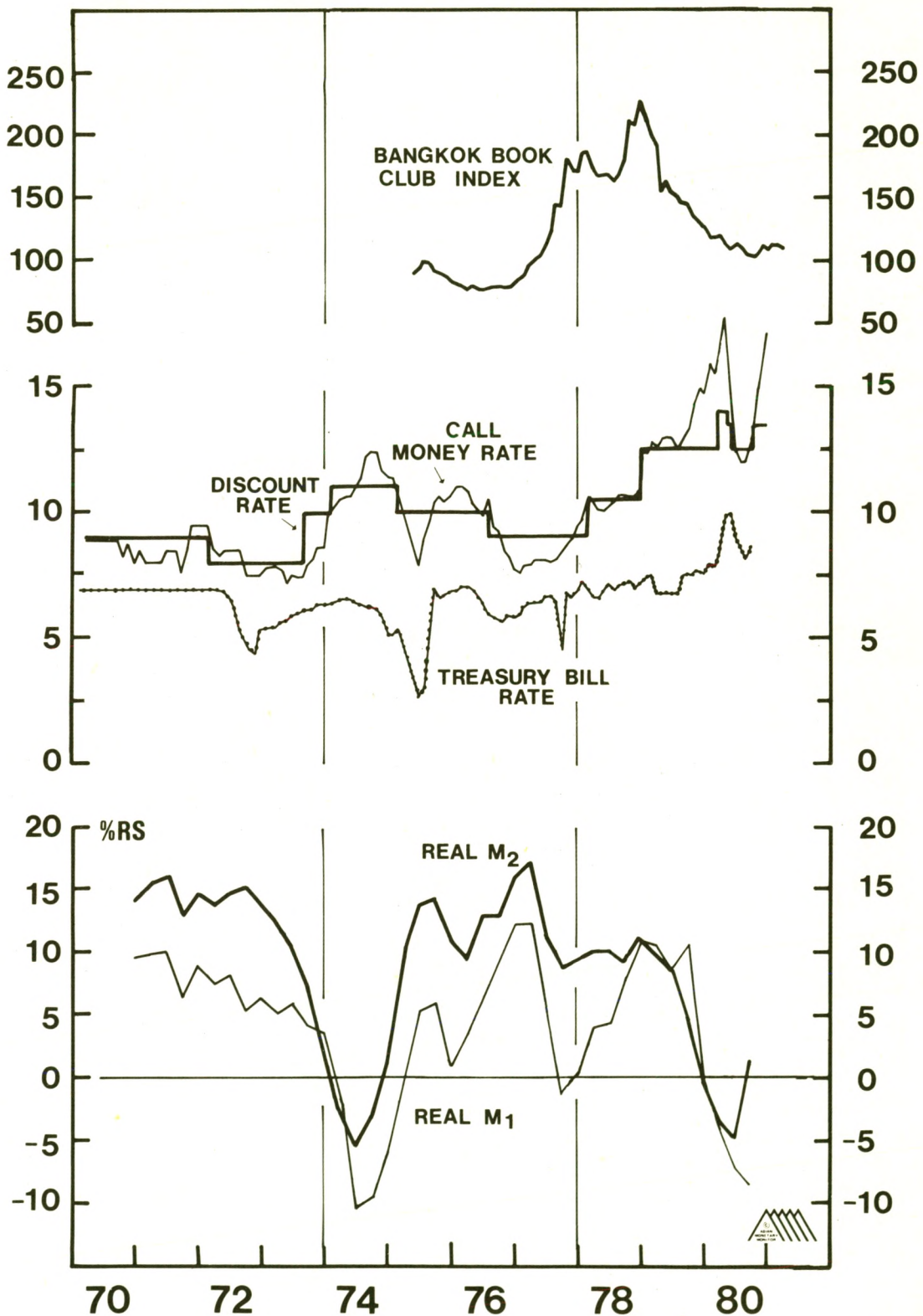
The government's own targets make it likely that there will be increased pressure on the Baht. The Minister of Finance - Amnuay Viravan - has stated that it is the government's plan to limit inflation to an average annual rate of 12% over the next five years. In the longer term Thailand can only maintain a fixed rate for the Baht to the US dollar if U.S. and Thai inflation rates are approximately the same. With inflation in the U.S. likely to decline in the coming year as a result of tight monetary policy and a weakening economy, the trend towards an over-valued Baht, evident in Chart 2, is likely to continue.

FORECAST: One can no longer rely on the Thai currency continuing to be pegged to the US dollar at the current rate. The continuing high level of inflation and the large current account deficit will exert progressively greater downward pressure on the exchange rate. Under the present economic circumstances, any depreciation of the Baht is likely to be relatively small - Chart 2 suggests that a devaluation of between 5% and 10% would re-establish the economy's overall price competitiveness. Nevertheless, Thailand's price competitiveness is likely to continue to deteriorate until the authorities follow a more restrictive monetary policy.

Interest rates are likely to remain high (the banks' call rate is currently 17½%) reflecting both the high rate of consumer and wholesale price inflation and the need to finance the current account deficit. Thus, unless the Thai government can step up its official borrowing programme even further, liquidity in the domestic economy is likely to remain tight. There is thus little prospect of a sustainable rise in the Thai stockmarket (Chart 3).

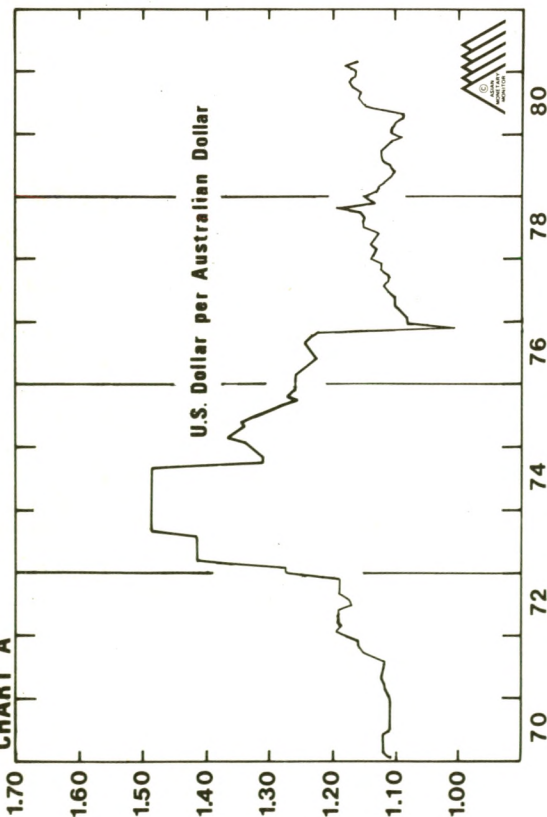
CHART 3 : THAILAND

THE STOCKMARKET AND LIQUIDITY INDICATORS



AUSTRALIAN DOLLAR

CHART A



In December 1980 the Australian dollar reached a two year high against the US currency. This strength has been achieved in the face of record levels of US interest rates. Nevertheless, a glance at the accompanying charts suggests that the Australian dollar has few of the credentials which usually characterise "strong" currencies.

A comparison of Charts B and D suggests that the Australian currency is over-valued relative to aggregate demand and inflationary pressures in the domestic economy. After an impressive trade account performance during 1979, export growth declined rapidly in the wake of a slowing world economy. At the same time the Australian economy continued to expand, with GNP growing 3% in real terms during 1980. This increase in domestic demand coupled with the appreciation of the Australian dollar sustained import growth at a high level. As a result the Australian trade balance deteriorated throughout 1980, and with the net deficit on service transactions more or less unchanged the current account deficit is now approaching the record levels of 1978.

The background to the weak external account and the relatively high level of inflation lies in the Reserve Bank's inability to reduce monetary growth in line with its stated targets. As a result of their

decision to peg domestic interest rates at an artificially low level, M_2 growth has fluctuated in the 11-13% range for the past two years. Thus whereas liquidity in most of Australia's trading partners has tightened during the past year, it has remained relatively "easy" in the domestic economy. These are not typically the economic circumstances characteristic of a strengthening currency.

However, the trend in the Australian dollar, in the short to medium term at any rate, is not determined by the free market. The Australian dollar is "managed" against a basket of currencies. In part, the relative strength of the Australian dollar against the US currency reflects the Reserve Bank's decision to appreciate the local currency against this basket of currencies (The trade weighted index rose by approximately 4½% during 1980 and the Reserve Bank was able to achieve this in spite of the rapidly weakening current account because of a very large increase in private inflows to finance resource development). A more important reason for the Australian dollar's recent strength is that the currencies it is managed against (principally the Yen and Sterling) have themselves been firm against the US dollar. Thus, as a consequence of the Reserve Bank's exchange management procedure, the Australian dollar is unlikely to weaken significantly against the US dollar providing the Yen and Sterling remain relatively firm. In the longer term, however, this "technical" strength will be undermined unless supported by policies reliably designed to reduce liquidity growth in the domestic economy.

ACTUAL

US\$/A\$	1980	Q4	1981	Q1	Q2	Q3
FORECAST A						
Actual Range		1.1633-1.1815		1.1509-1.1885	1.13-1.19	1.08-1.14
FORECAST B					1.13-1.19	1.13-1.17

FORECAST

Forecast A assumes that Australia's trade position does not deteriorate over the next six months, but that US interest rates begin rising during the third quarter of 1981 signalling the American authorities' intention to sustain a deflationary stance.

Forecast B assumes that Australia's trade position does not deteriorate over the next six months and that there is no significant upturn in US interest rates during the third quarter of this year.

CHART B
TRADE PERFORMANCE

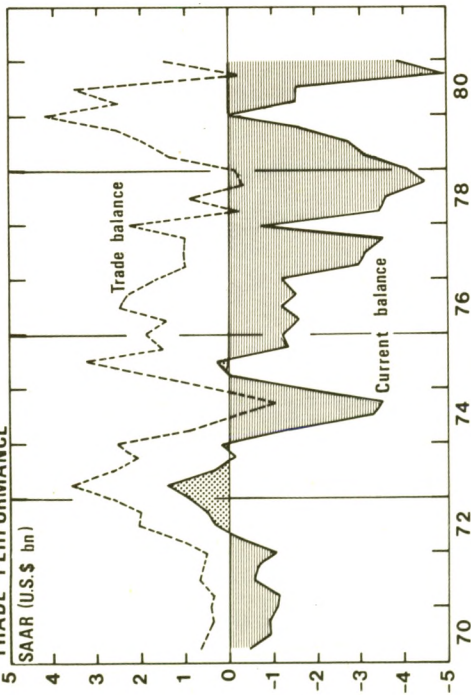


CHART C
INTEREST RATE DIFFERENTIAL

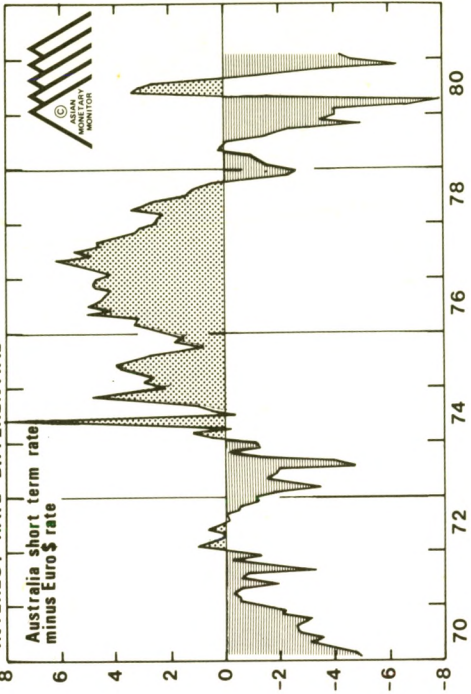


CHART D
PRICE COMPETITIVENESS (adjusted for exchange rate changes)

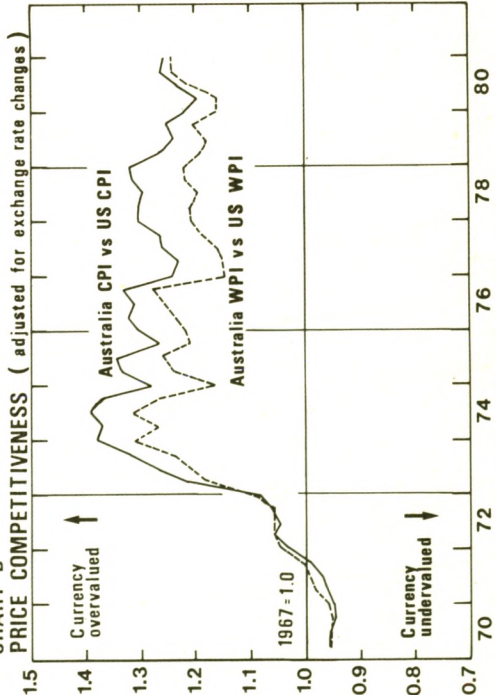
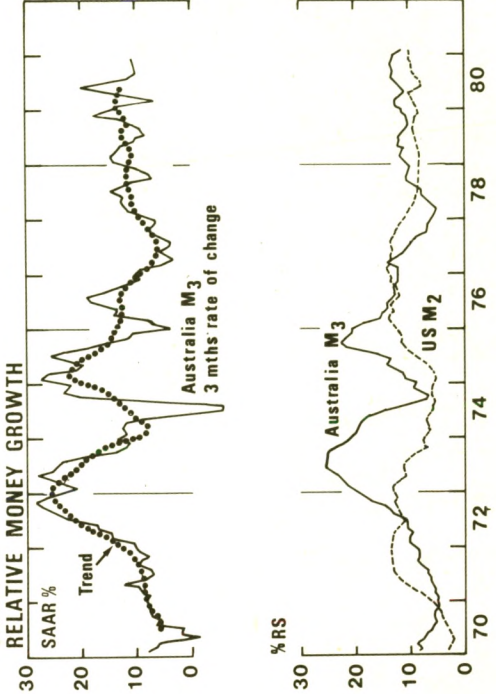
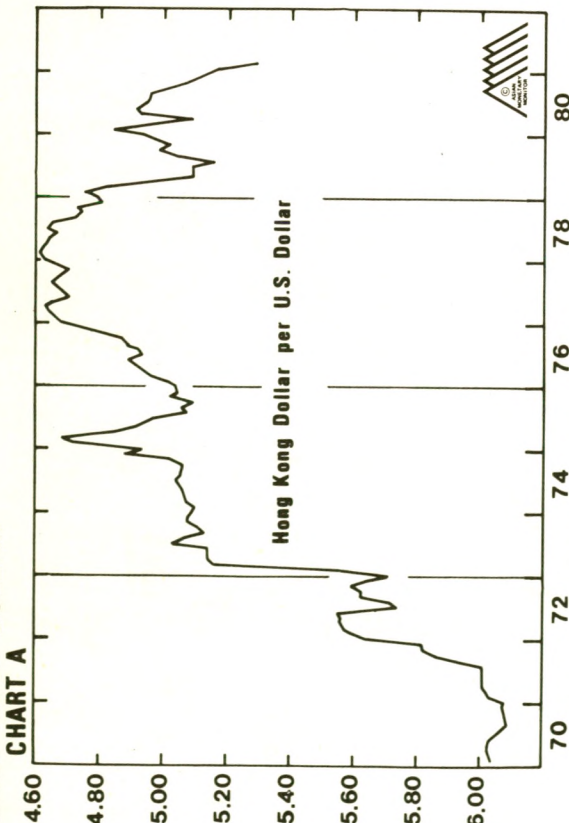


CHART E
RELATIVE MONEY GROWTH





The Hong Kong dollar remains a fundamentally weak currency. An examination of Charts B, D and E shows that the major fundamental indicators of short and longer term currency strength point to continued depreciation of the Hong Kong dollar against the US dollar and other major currencies.

The most important feature of Hong Kong's current economic climate continues to be the very rapid growth of the money supply. Monetary growth appears to be levelling off in response to the record level of domestic interest rates, but M_2 has nevertheless risen at an average year-to-year rate of approximately 40% in the last five months. This acceleration in monetary growth rivals the 1972 episode, both on an absolute basis and relative to the USA. On these grounds alone one should be alert to the possibility of further weakness in the Hong Kong dollar against the US dollar in the coming months.

Moreover we consider it unlikely that the currently excessive rate of monetary expansion will be followed by a period of severe contraction, as occurred during 1973 and the first quarter of 1974. (It was the particularly sharp squeeze over this period which paved the way for a strong Hong Kong dollar once the Hong Kong currency was allowed to float at the end of 1974.) During that period the

pegged exchange rate acted as an external constraint forcing deflation on the overheated domestic economy. The adjustment mechanism meant that excessive monetary growth could not continue for very long. However, that constraint no longer exists, and excess monetary growth can now continue indefinitely. As we have argued in many previous issues of AMM, with the present array of monetary instruments and the present institutional arrangements, there is no reliable method of controlling bank reserves and hence controlling monetary expansion. So far there is no evidence whatever that the authorities' misguided attempts to manipulate interest rates and thereby restrict monetary growth are having any success at all. Inflationary pressures and strong import demand are therefore likely to continue. Thus in contrast to the 1973-74 period when "adjustment" of an overheated domestic economy to a worldwide recession took the form of a severe economic downturn (followed by an appreciation of the exchange rate once it had been floated), it is likely that the "adjustment" in this cycle will continue to be manifested in a persistently weakening exchange rate. Domestic demand, meanwhile, is likely to remain firm.

ACTUAL FORECAST

HK\$/US\$	1980 Q4	1981 Q1	Q2	Q3
FORECAST A				
Actual Range	4.98-5.19	5.12-5.38	5.20-5.50	5.35-5.65
FORECAST B			5.20-5.40	5.20-5.40

Forecast A

assumes that Hong Kong's trade position does not deteriorate any further over the next six months, but that US interest rates begin rising during the third quarter of 1981 signalling the American authorities' intention to sustain a deflationary stance.

Forecast B

assumes that Hong Kong's trade position does not deteriorate any further over the next six months and that there is no significant upturn in US interest rates during the third quarter of this year.

CHART B
TRADE PERFORMANCE

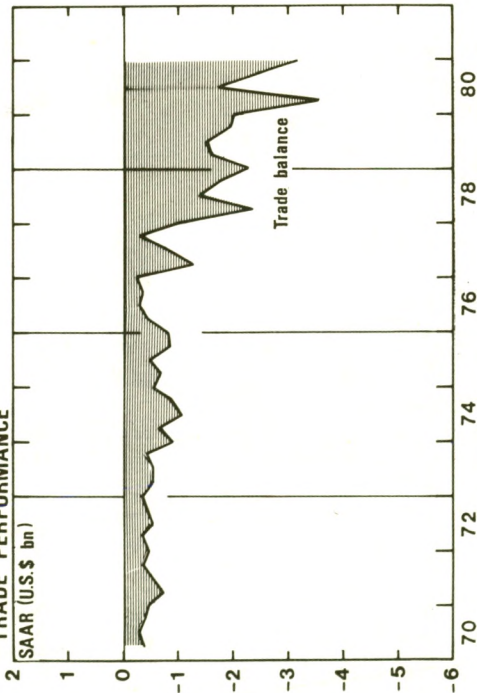


CHART C
INTEREST RATE DIFFERENTIAL

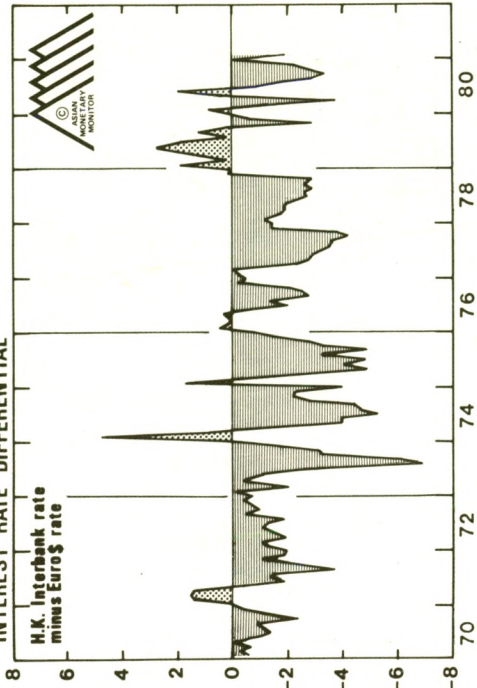


CHART D
PRICE COMPETITIVENESS (adjusted for exchange rate changes)

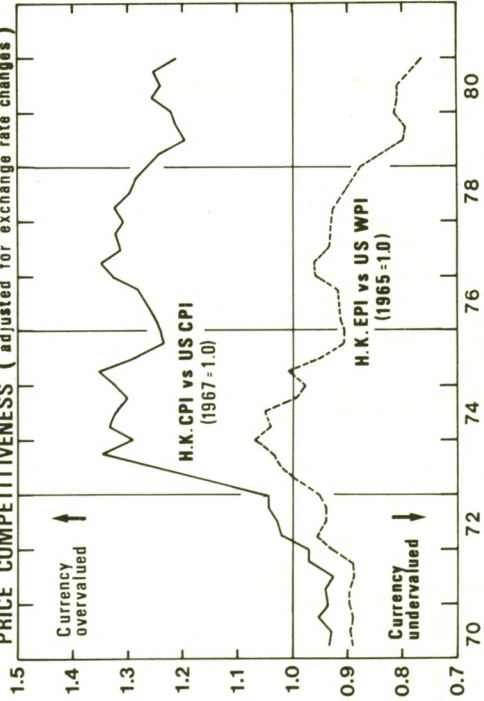
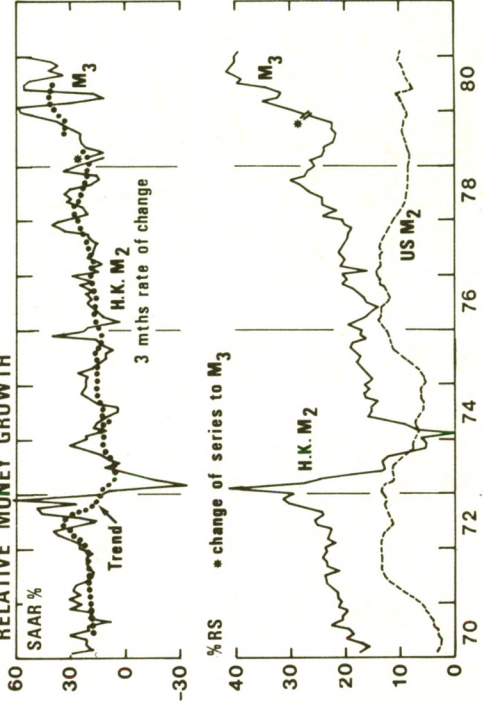


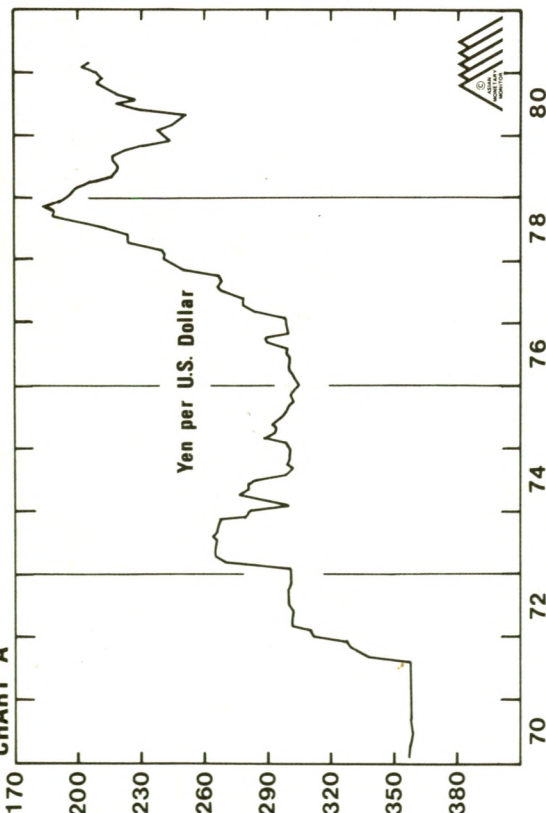
CHART E
RELATIVE MONEY GROWTH



EPI : EXPORT PRICE INDEX
SAAR: SEASONALLY ADJUSTED AT ANNUAL RATE
RS: RATE OF CHANGE OVER SAME MONTH OF PREVIOUS YEAR

JAPANESE YEN

CHART A



In spite of relatively a strong performance against most other currencies, the yen's slight weakness against the US dollar towards the end of the first quarter of this year has prompted fears that the Japanese currency may be close to a cyclical peak. Various factors have contributed to the yen's failure to remain above the US\$1=200 level, including renewed threats of US restrictions on the importation of Japanese products. However in our view the most important variable behind the relatively strong performance of the US dollar against the Japanese currency has been market fears of a continuing high level of US interest rates. Speculation that US rates would remain high occurred just at the time when the Japanese authorities were discussing the size and timing of a further reduction in the Official Discount Rate.

In our view, the foreign exchange market's recent preoccupation with the interest rate differential between the yen and the dollar will prove to be temporary. A comparison of Charts A and C indicates that there is no lasting relationship between the Japan - US interest rate differential and the yen/US dollar rate. Fundamental factors such as Japan's trade performance and price competitiveness have been more influential determinants, and, as may be seen from Charts B and C these variables remain very favourable for the yen.

At present Japanese exports are growing some 20% faster than Japanese imports (as measured in US dollar terms). This implies that the favourable trend in Japan's external account is likely to continue during the coming months. In previous business cycles the trend in Japan's external account has been an important indicator for the strength of the yen. The large gap between export growth and import growth also provides useful corroborative evidence of Japan's overall price competitiveness as summarised in Chart D. Together, Charts B and D indicate that the yen is still very competitively priced against the US dollar at around current levels.

The main risk to our projections lies with the management of the US economy during the third quarter of 1981. We are confident that the recent period of tight monetary policy will lead to a weaker economy in the second quarter of this year. As the economy weakens US interest rates will decline, producing downward pressure on the US dollar. However it remains to be seen what the US authorities policy will be once the economy reaches its trough. Any rise in US interest rates at that time would impede further yen strengthening whilst simultaneously boosting the longer term prospects for the US dollar.

ACTUAL

Yen/US\$	1980	Q4	1981	Q1	1981	Q2	Q3
FORECAST A							
Actual Range		202.80-217.80		199.15-211.00		195-215	195-215
FORECAST B						195-215	190-208

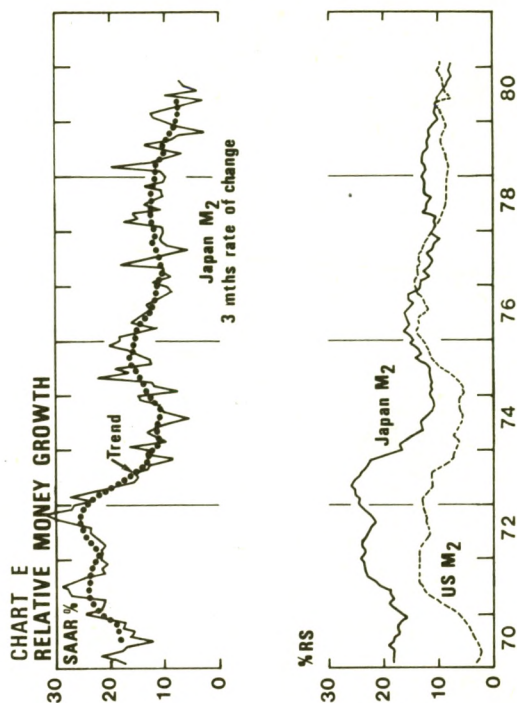
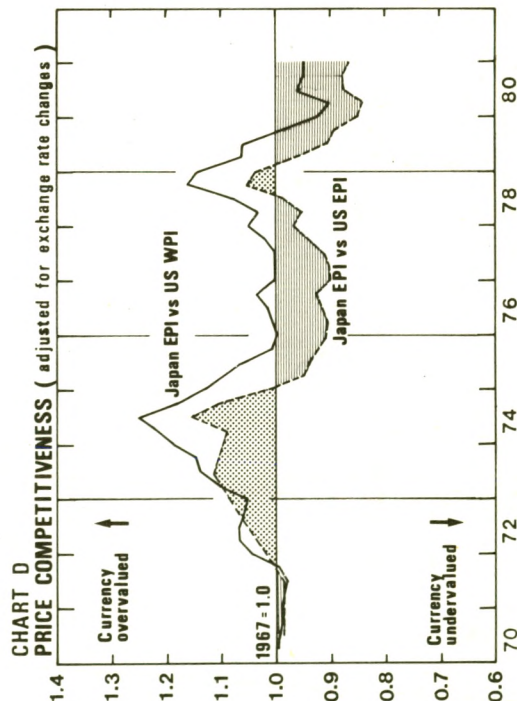
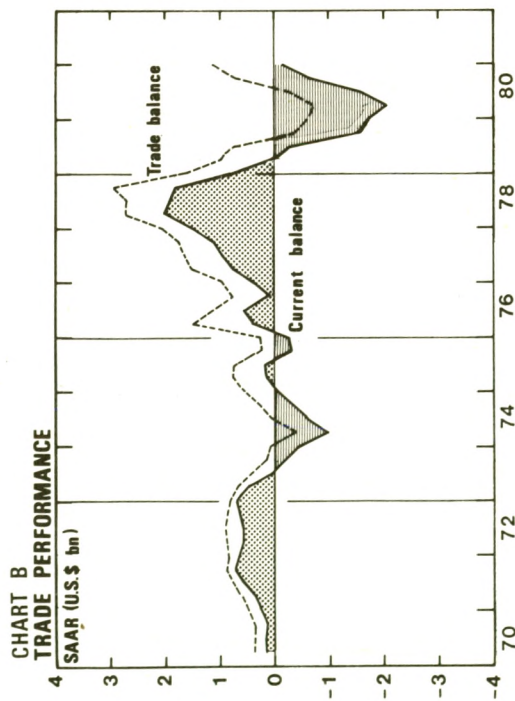
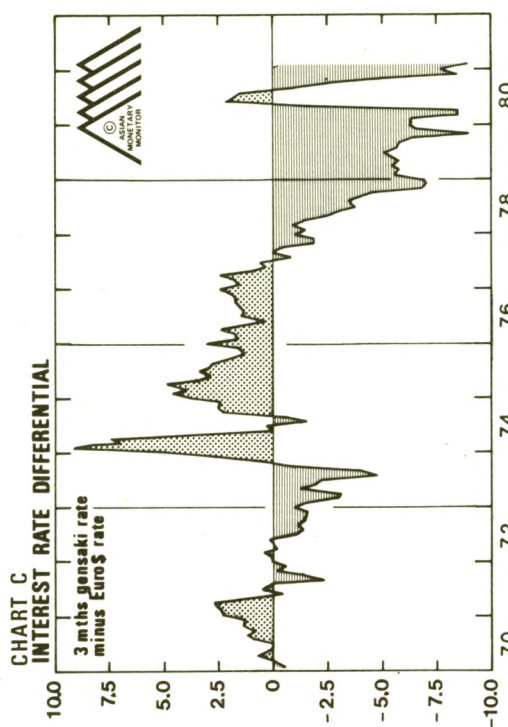
FORECAST

Forecast A

assumes that Japan's trade position will continue improving over the next six months, but that US interest rates begin rising during the third quarter of 1981 signalling the American authorities' intention to sustain a deflationary stance.

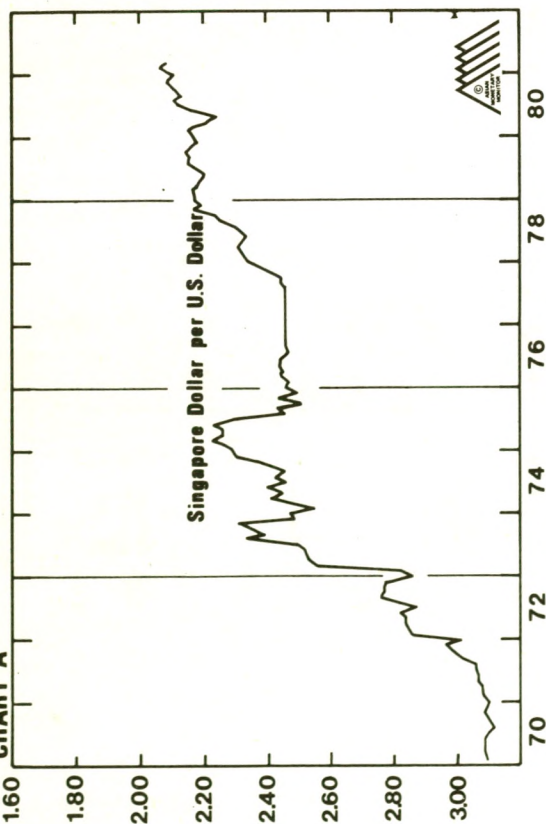
Forecast B

assumes that Japan's trade position will continue improving over the next six months and that there is no significant upturn in US interest rates during the third quarter of this year.



SINGAPORE DOLLAR

CHART A



Over the last twelve months the Singapore dollar has been one of the world's strongest currencies. From a low of \$2.24=US\$1 in March 1980, the Singapore dollar appreciated steadily to a high of \$2.065=US\$1 in January of this year. Aided by higher local interest (see Chart C) the Singapore dollar was one of the few currencies to appreciate against the US dollar during the last quarter of 1980, when US prime rates rose to 21½%. The Singapore dollar, aided by a favourable interest differential, also strengthened against the Malaysian Ringgit reaching a premium of between 8% and 9% against the Malaysian currency during January/February 1981.

The background to the impressive performance of the Singapore dollar lies fundamentally in the country's relatively low rate of inflation (consumer prices rose by 5.9% in the year to February 1981) and, in spite of a deteriorating trade position, a broadly balanced external account. The low level of inflation has enabled Singapore to maintain its overall price competitiveness despite the recent appreciation of the Singapore dollar. It is therefore unlikely that the Singapore dollar will experience marked weakness in the coming months. In past business cycles sharp depreciations in the Singapore currency, as at the beginning of 1974 and during mid-1975, have followed periods when the Singapore dollar became

significantly overvalued in terms of overall price competitiveness. (Compare Charts A and D.)

Nevertheless, the surge in Singapore's money supply during the last year (see Chart E) threatens to undermine the fundamental strength of the Singapore dollar. The increase in monetary growth commencing in the last three months of 1979 is clearly much more rapid than the rise that presaged the period of downward pressure on the Singapore dollar during 1974 and 1975. Moreover, it comes at a time when US interest rates are likely to remain high, reflecting the US authorities' desire to maintain a deflationary stance. Thus unless monetary growth is quickly curtailed one should be alert to the possibility that the Singapore dollar will weaken against the US\$. If high rates of monetary growth continue under the reorganised MAS this would indicate that the Singapore authorities are effectively pursuing an "easier" policy towards inflationary and import pressures. In these circumstances any rise in US interest rates could encourage the foreign exchange markets to focus on the possibility of weakness in the Singapore currency.

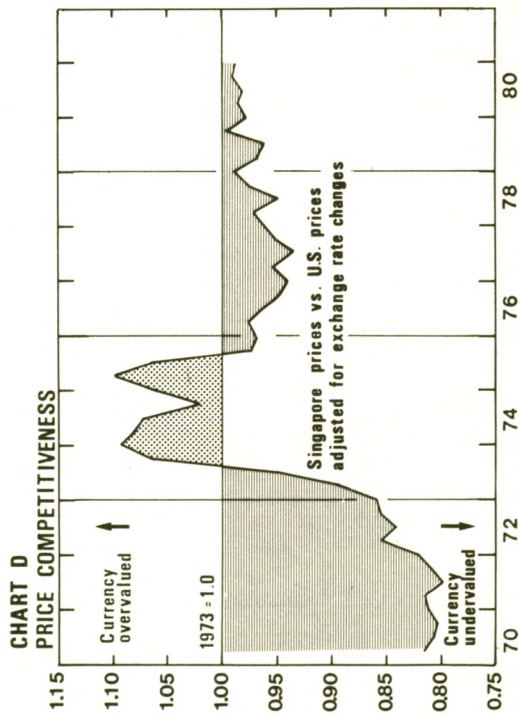
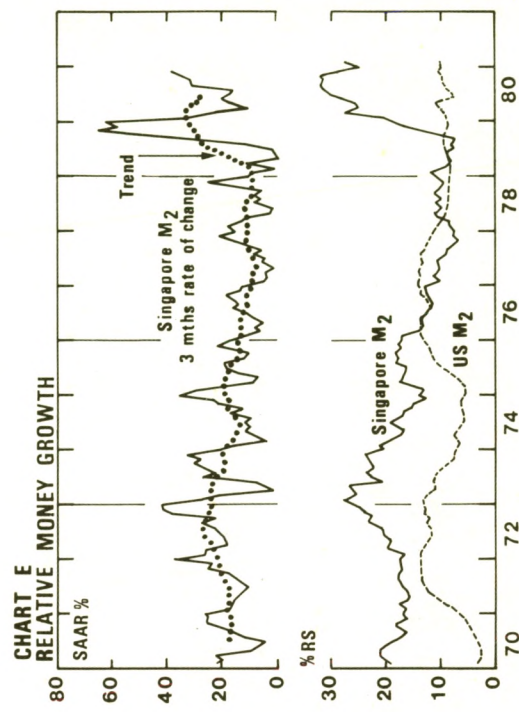
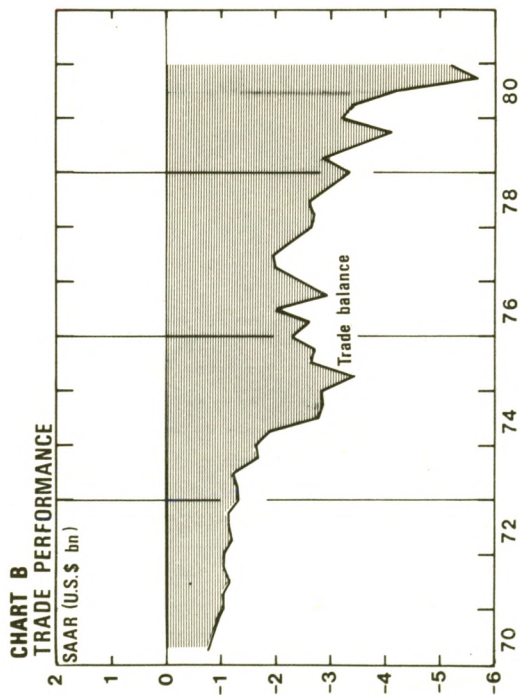
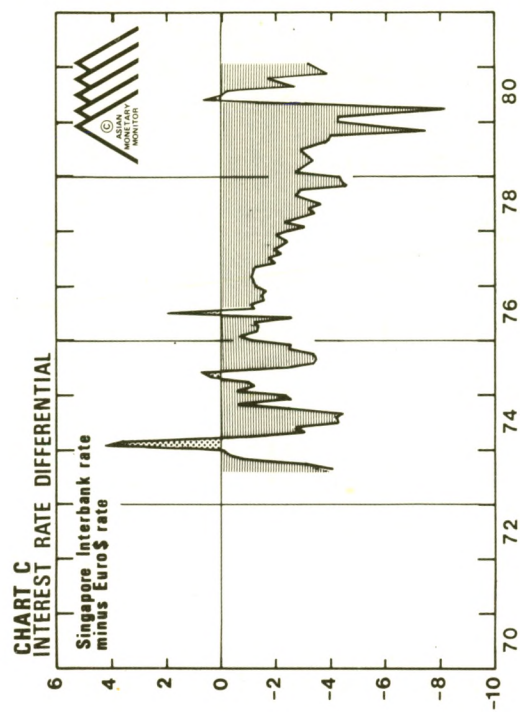
ACTUAL

FORECAST

S\$/US\$	1980 Q4	1981 Q1	Q2	Q3
FORECAST A				
Actual Range	2.1250-2.07	2.11-2.065	2.13-2.08	2.15-2.08
FORECAST B			2.15-2.08	2.20-2.12

Forecast A assumes that Singapore's trade position will not deteriorate over the next six months, but that US interest rates begin rising during the third quarter of 1981 signalling the American authorities' intention to sustain a deflationary stance.

Forecast B assumes that Singapore's trade position will not deteriorate over the next six months and that there is no significant upturn in US interest rates during the third quarter of this year.



An Index of AMM articles published in Vol. 4

<u>REGIONAL SURVEY</u>	: Some Basic Truths about Inflation. (4/2)
<u>AUSTRALIA</u>	: A Decline in the Trade Surplus. (4/3) The Balance of Payments and the Basket. (4/6)
<u>HONG KONG</u>	: The Temporary Strength of the Hong Kong Dollar. (4/1) The Direction of Interest Rates in this Cycle. (4/4) Correcting for Inadequate Statistics. (4/5)
<u>INDONESIA</u>	: The Aftermath of Devaluation. (4/1)
<u>JAPAN</u>	: The Recovery of Corporate Profits. (4/2) The Prospects of Easier Liquidity. (4/3) How to Cope with an Oil Crisis - A Textbook Case. (4/5) The Impact of Interest Rate Liberalisation. (4/6)
<u>KOREA</u>	: Alleviating the Pressure. (4/1) Monetary Acceleration Undermines Devaluation. (4/4)
<u>PHILIPPINES</u>	: Internal Expansion and External Weakness. (4/3)
<u>SINGAPORE</u>	: Monetary Restraint Abandoned. (4/3)
<u>TAIWAN</u>	: Slower Growth. (4/1)
<u>THAILAND</u>	: An Involuntary Squeeze. (4/2)

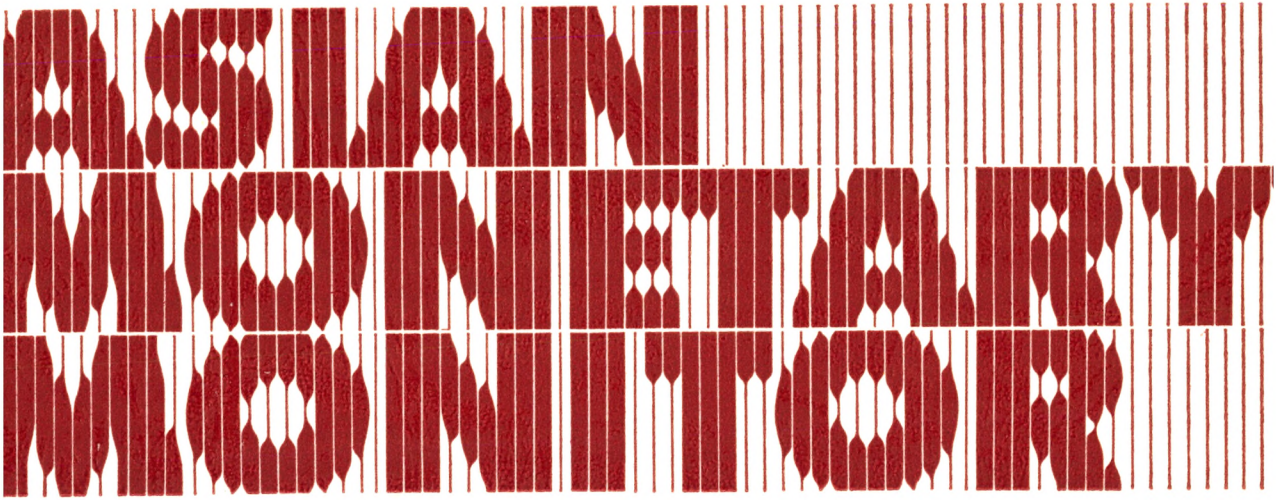
EXCHANGE RATE FORECASTS

	4/4	4/5	4/6
Australian Dollar	*		
Hong Kong Dollar	*		
Indonesian Rupiah			*
Japanese Yen	*		*
Korean Won		*	
Malaysian Ringgit		*	
New Zealand Dollar			*
Philippine Peso		*	
Singapore Dollar	*		
Taiwan N.T. Dollar		*	
Thai Baht			*



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CONTENTS

Page

SPECIAL ARTICLE:

Where the Bundesbank Has Gone
Astray: A Comparison of Monetary
Policy, Exchange Rate Policy, and
the Business Cycle in West Germany
and Japan

PHILIPPINES:

The New Governor Faces Two Crises

2

EXCHANGE RATE FORECASTS:

Japanese Yen

3

Thai Baht

3

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CONTENTS

	Page
SPECIAL ARTICLE	2
Where the Bundesbank Has Gone Astray: A Comparison of Monetary Policy, Exchange Rate Policy, and the Business Cycle in West Germany and Japan	
PHILIPPINES	25
The New Governor Faces Two Crises	
EXCHANGE RATE FORECASTS:	
Japanese Yen	36
Thai Baht	38

KEY TO SYMBOLS USED IN THE CHARTS

% RP - Percentage Rate of change over Preceding period.

% RS - Percentage Rate of change over Same period of preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

WHERE THE BUNDESBANK HAS GONE ASTRAY:

A COMPARISON OF MONETARY POLICY, EXCHANGE RATE POLICY, AND THE BUSINESS CYCLE IN WEST GERMANY AND JAPAN.

By the autumn of 1978, both the Japanese and West German economies had become the envy of many other developed countries. In contrast to low growth, high inflation economies such as the US and the UK, Japan and W. Germany displayed rude health in virtually all aspects of their economic performance. Both countries enjoyed an apparently elusive combination of high real rates of growth, falling unemployment, moderate inflation and low interest rates. Unlike in the US, relatively strong aggregate demand in the domestic economy was not reflected in weaker external sectors. Low inflation and rising productivity led to strength in both the Deutschemark and the yen as both economies earned large current account surpluses during this period.

The capital markets in both economies flourished in this environment. Long dated fixed interest securities were close to their highest prices for a decade, whilst at the same time stock prices surged. West Germany's Commerzbank share index reached an all time high in October 1978, and the Japanese TSE (First Section) index hit a cyclical peak of 462 in December of the same year.

However, during the last two and a half years the relative position of Japan and W. Germany has altered considerably. This is summarised in Tables 1 and 2. Charts 1 and 2 show the basic trends in money, output and prices for the two economies, while Charts 3 and 4 show the contrast in some important cyclical indicators for Japan and Germany in recent years. The first three months of 1981 have proved to be an anxious period for the German economy. The German currency slumped to a three year low against the US dollar, and a five year low against sterling, in spite of a defensive increase in domestic interest rates which rose to double digits for the first time since 1974. The rise in short term interest rates encouraged pessimism for the real economy. Industrial production plunged nearly 6% in the year to March, and the decline in economic activity has worsened the prospects for this year's federal deficit, which it is now widely estimated will be in excess of DM35 billion as against a budgeted figure of DM27 billion. More seriously, the trade balance has continued to deteriorate and the current account deficit remains close to record levels.

The brightest aspect of W. Germany's current economic climate remains inflation. Consumer price inflation has been steady at around 5½% over the last nine months. Nevertheless, even this moderate inflation rate is substantially higher than the levels of 1978 and 1979, and with a weaker Deutschemark leading to higher import and wholesale prices there are fears that consumer price inflation will rise. Relatively low inflation has followed the Bundesbank's stringent monetary policy over the last eighteen months (see Charts 2 and 4),

where yearly M3 growth has ranged between 4% and 7% as a result of rising real interest rates aided by a large external outflow. However, even this aspect of economic policy received criticism recently when the W. German Chancellor, Herr Schmidt, encouraged the Bundesbank to ameliorate the current recession by reducing local interest rates and relaxing its tough monetary stance. The W. German economy's reputation for high growth, low inflation, and a strong currency is apparently being besieged on all fronts.

TABLE 1

OUTLINE COMPARISON OF THE JAPANESE ECONOMY IN SEPTEMBER 1978 AND MARCH 1981

		<u>September 1978</u>	<u>March 1981</u>
Inflation:	CPI % RS	3.7	6.2
	WPI % RS	- 3.7	1.8
Industrial Production	% RS	7.4	
Official Discount Rate		3.5	6.25
M2*	% RS	12.5	7.7
Current Account** (US\$ billion)		+14.72	- 4.52
Exchange Rate	US\$1.00 =	¥189.15	¥211.35
Terms of Trade		115.1	76.85

TABLE 2

OUTLINE COMPARISON OF THE W. GERMAN ECONOMY IN SEPTEMBER 1978 AND MARCH 1981

		<u>September 1978</u>	<u>March 1981</u>
Inflation:	CPI % RS	2.3	5.5
	WPI % RS	1.3	7.0
Industrial Production	% RS	4.7	- 5.9
Official Discount Rate		3.0	7.5
M3	% RS	12.6	5.5
Current Account** (US\$ billion)		8.2	-14.7
Exchange Rate	US\$1.00 =	DM1.939	DM2.108
Terms of Trade		101.35	89.0

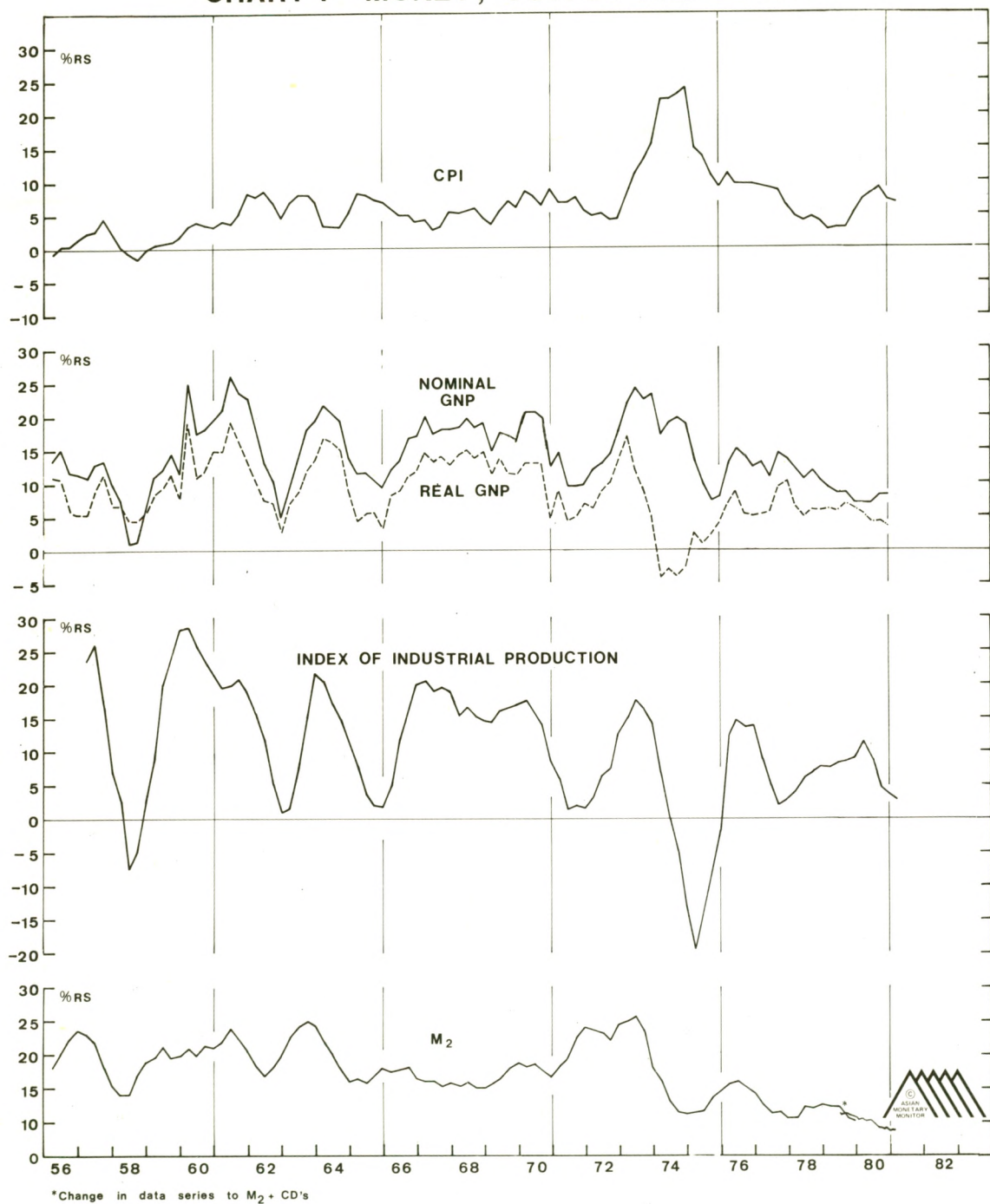
* March 1981 : M2 plus CDS

** Four quarter moving total

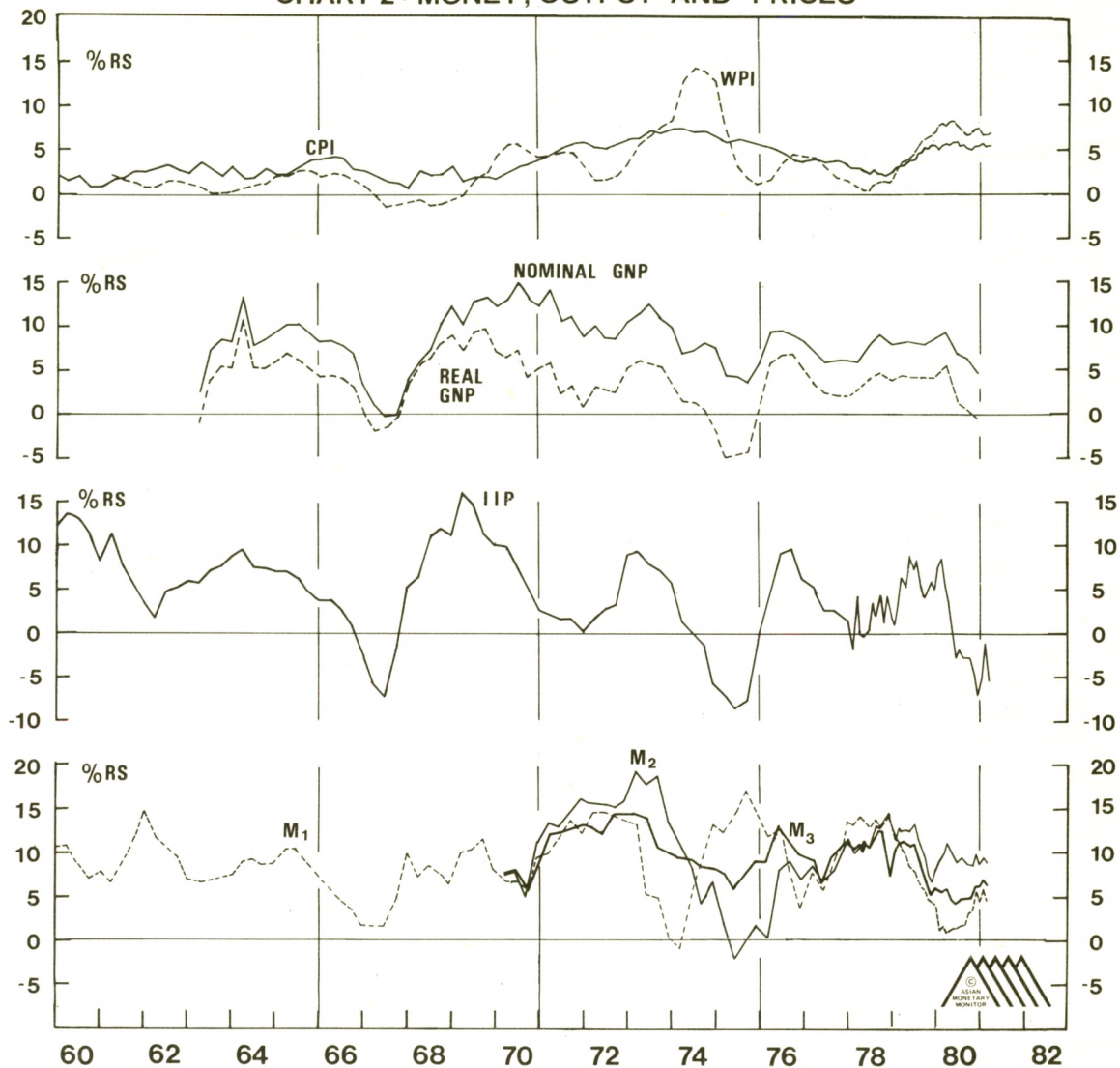
Of course the overall position of the Japanese economy has also deteriorated somewhat since autumn 1978. The most visible changes are in the external sector. Japan's current account position has fallen markedly during the past two and a half years with a surplus of US\$14.7 billion in the year to September 1978 being quickly eroded to a deficit of US\$4.5 billion in the year to March 1981, and this decline has been an important factor behind the weaker yen-US dollar rate. Japan's domestic indicators also apparently indicate a weaker position now than at the end of 1978: industrial production and profitability are both down, interest rates are higher and inflation appears to have accelerated.

JAPAN

CHART 1 : MONEY, OUTPUT AND PRICES



W. GERMANY
CHART 2: MONEY, OUTPUT AND PRICES



Nevertheless it is clear that by most criteria the Japanese economy appears to have fared better over the last two and a half years than West Germany. Domestic interest rates are lower, and have increased by a smaller proportion, than in West Germany. Industrial production has remained at a higher level, and the decline in Japan's current position has been less serious than in West Germany.

However it is obvious from a glance at Charts 3 and 4 which summarise recent economic experience in Japan and West Germany, that a simple comparison of two arbitrarily chosen periods is of only limited value. It is clear that at the present time the Japanese business cycle is in a very different stage from its West German counterpart. Japanese inflation, for example, (both in terms of wholesale and consumer prices) is now declining whilst inflation in West Germany is steady or rising. Unlike in West Germany, where the Official Discount Rate has remained at the level established in March 1980, the Japanese Official Discount Rate has already been reduced in three stages from 9% to 6.25%. Moreover, in the external sector, both Japan's trade and current accounts are now moving into surplus after the large deficits experienced in the second half of 1979 and 1980, and this has been reflected in a cyclical improvement in the yen in spite of the rise in US interest rates in the second half of 1980. By comparison, the West German current account has continued to deteriorate throughout 1980 and on into the early months of this year, and the Deutschemark has proved to be a weak currency in spite of West Germany's relatively favourable record on inflation. Overall we can say that the Japanese business cycle is now in a stage where "liquidity" is becoming gradually easier, whereas "liquidity" in West Germany remains tight. This is reflected in the two countries' capital markets. Long bond yields in Japan are around one and a half percentage points lower than their peak in March 1980 whereas the combination of tight domestic liquidity and rising US interest rates have forced yields on Deutschemark debt close to post war highs during the first quarter of 1981. Similarly West German equity prices now languish at close to their lowest levels of the past six years, but Japan's TSE index is currently at an all time high.

Thus the most important questions become: how do we account for the marked differences in the trends in these two economies from their apparently healthy position two and a half years ago? What is there that can be learned from this recent period in order to analyse and describe any fundamental differences in the business cycles within Japan and West Germany? What, if anything, might this imply for the future course of economic activity in both countries? What repercussions do these have for their respective capital markets and for their currencies?

To begin with, we feel that it is necessary to discuss some of the factors often blamed for economic malaise, or downturns, and examine to what extent these variables may have been responsible for the different economic experience of Japan and West Germany recently.

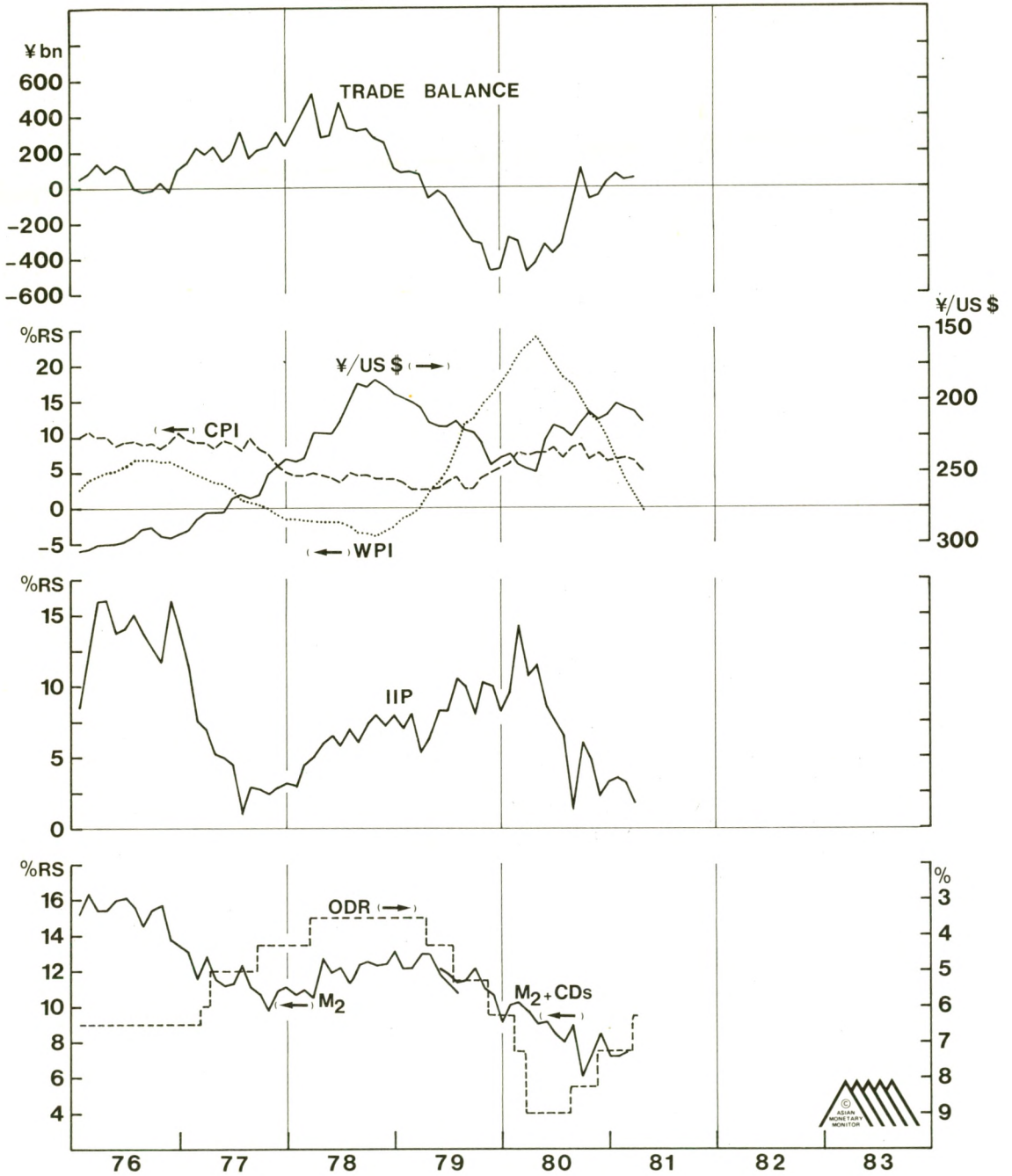
One influence which has been frequently linked with West Germany's mediocre performance this year is fears about the rise in the size of the government sector of the economy. However, whilst it is certainly true that the government deficit as a percentage of GNP has increased rapidly over the last five years - from approximately 1% in 1974 to 2% in 1980* - the bulk of this increase occurred in the period before 1978, and there has actually been a slight improvement in the period since 1980. However it appears that the increase in the West German Government's deficit spending is not, on its own, sufficient to explain differences in the trend of economic activity in comparison with Japan. For Japan's fiscal deficit as a proportion of GNP soared from 1.3% in 1974 to 6.5% in 1978 before declining to an estimated 5.6% in 1980. These broad measurements indicate that it is unlikely that the differing performance of Japan and West Germany can be attributed to their respective fiscal policies.

The present weakness of the West German economy is also sometimes attributed to the fact that it is a relatively "open" economy. As such - or so the argument runs - the economy has suffered as a consequence of the steep rise in oil prices during 1979, and a general decline in world economic activity during the past eighteen months. An economy's "openness" is usually defined as the ratio of total exports plus total imports to Nominal GNP. In calendar year 1980 the value of this ratio was 46.1% for West Germany, up from 40.8% in 1978.* The comparable figures for Japan in these two years were 24.95% and 18.2% respectively so that, apparently at least, West Germany has been potentially more vulnerable to adverse external shocks than Japan. However we doubt the validity of this particular argument for a number of reasons. The most important external change in the recent past was probably the quadrupling of oil prices in 1979. Whereas petroleum imports to West Germany now form 18.7% of total imports, in Japan the comparable figure is a colossal 40.9%.* Japan's petroleum imports represented an enormous 5.3% of nominal GNP in 1980, or more than double their proportion in 1978. West Germany's petroleum imports, in contrast, formed 4.2% of GNP in 1980, an increase from 2.4% in 1978. Overall, Japan's terms of trade have fallen by no less than 33.3% (see Table 1) since 1978, whereas West Germany has registered a smaller 12.2% fall in its terms of trade.

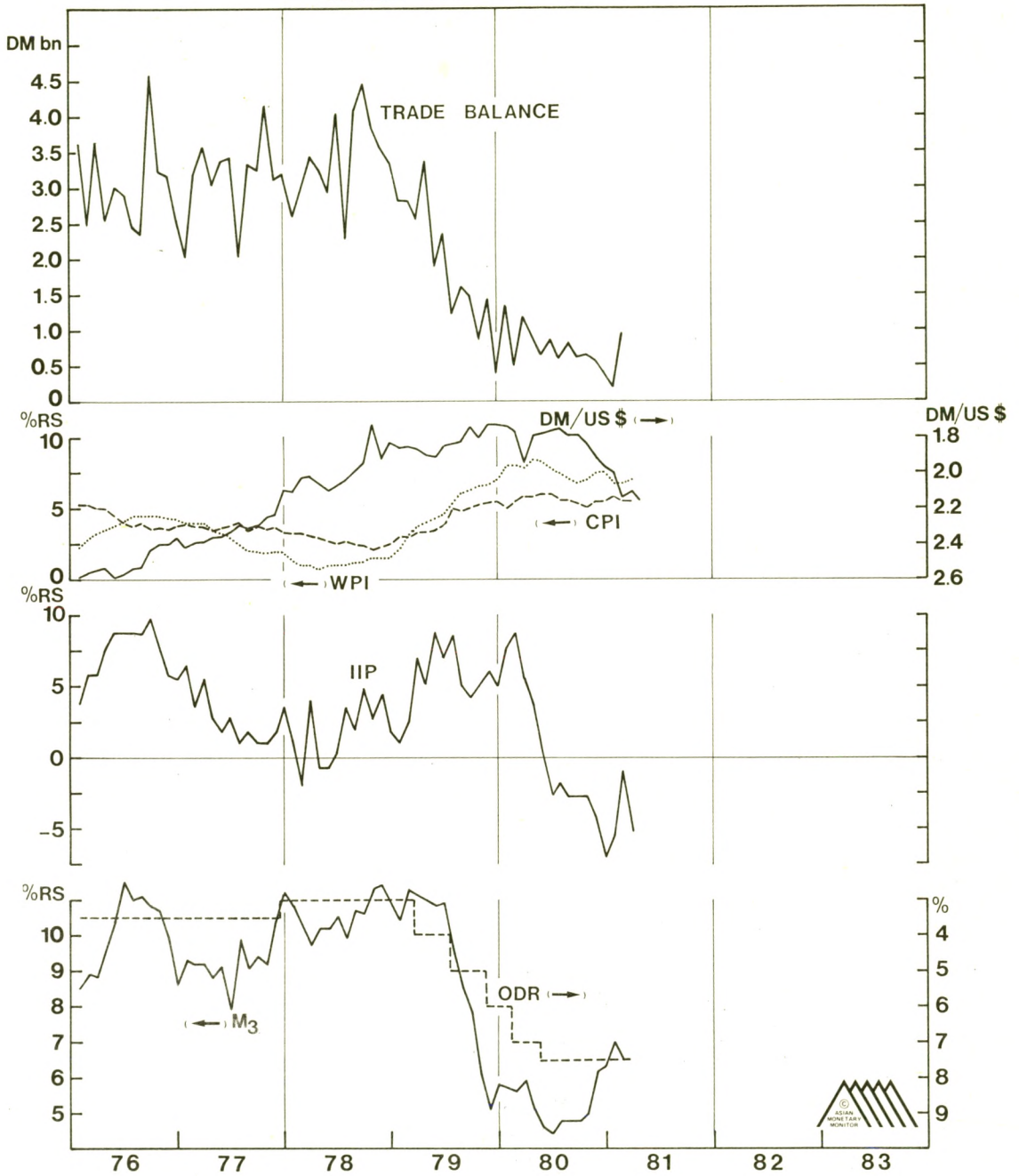
It is therefore clear that, even if the relative "openness" of an economy is an important influence of the level of domestic economic activity, Japan has suffered at least as much as West Germany from external shocks during the last two years. Both countries have been forced to make painful adjustments in terms of exporting relatively more of their national output and consuming less. The impact of changes in world demand, and in relative prices, is therefore an inadequate explanation of the relative performance of the Japanese and West German economies. Moreover, it is not generally the case that the "openness" or otherwise of an economy is an important determinant of economic

* Source: International Financial Statistics

JAPAN: CHART 3
RECENT CYCLICAL INDICATORS



W. GERMANY: CHART 4
RECENT CYCLICAL INDICATORS



activity in that economy. Total imports plus exports amounted to 404.4% of Singapore's Nominal GNP in 1980, 197.8% of Hong Kong's, 66.5% of South Korea's, 92.1% of the Netherlands, and 35.3% of France's. Nevertheless, real GNP growth in these countries did not reflect their apparent vulnerability to changes in global trading conditions: real growth in Singapore in 1980 amounted to 10.2%, 9.0% in Hong Kong, -3.4% in South Korea, 1.2% in the Netherlands, and 1.3% in France.

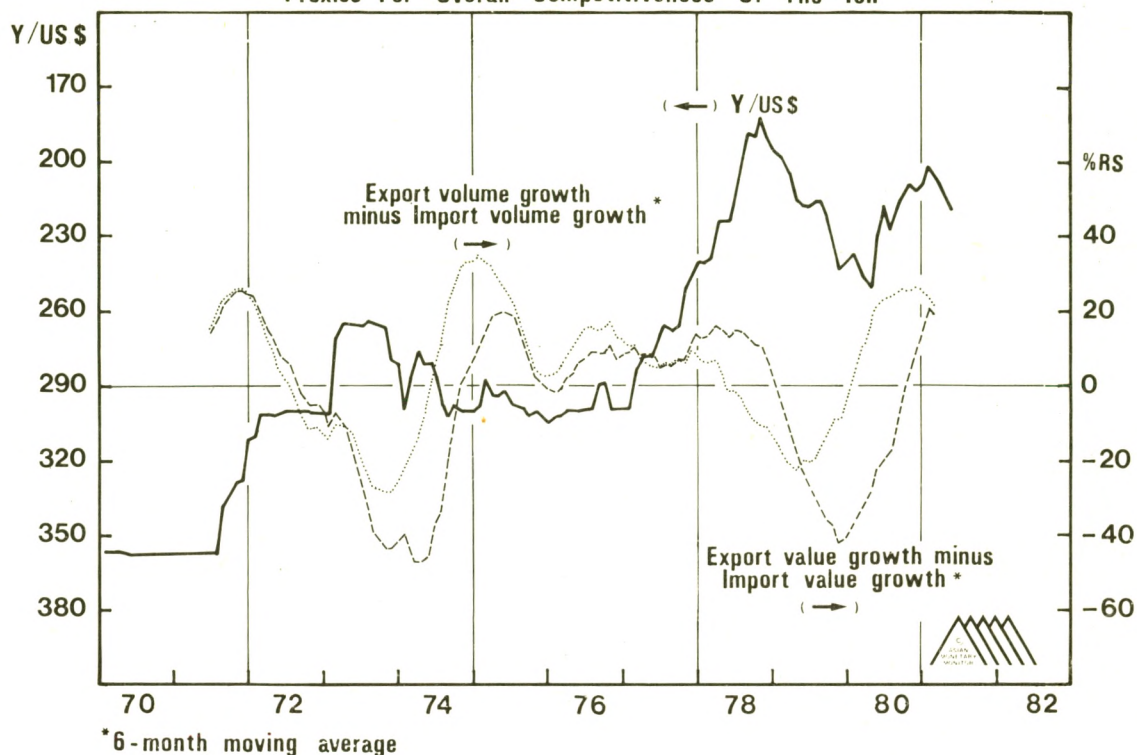
Of course, the two factors examined above have an important role to play in an economic analysis of any country, but nevertheless they do not provide a good explanation of the central question in this article: What is the fundamental difference between the business cycle, or economic adjustment process, in West Germany and Japan?

In trying to outline the basic differences in the Japanese and West German business cycles we shall start by describing the likely source of West Germany's current problems. It seems probable that the underlying reason for pessimism in the West Germany at present is that the economy is now in the late stages of adjustment to the environment of 1979 and the first half of 1980 where the Deutschemmark was substantially overvalued relative to aggregate demand within the domestic economy. This assertion may appear surprising in view of West Germany's low inflation rate relative to its trading partners. Nevertheless it is true, as may be gauged by the trend in West Germany's external account during the last two to three years. From a roughly balanced position in 1978 (see Chart 6) West German export growth deteriorated rapidly relative to its import growth. By the end of 1979, when the Deutschemmark was quoted at DM1.75=US\$1 and with real GNP growth up by 4% year-on-year, import growth was outstripping export growth by around 15%. This gap represented a post-war record. The inference is clear: in spite of a good performance on inflation, the Deutschemmark was in that period in danger of becoming chronically uncompetitive.

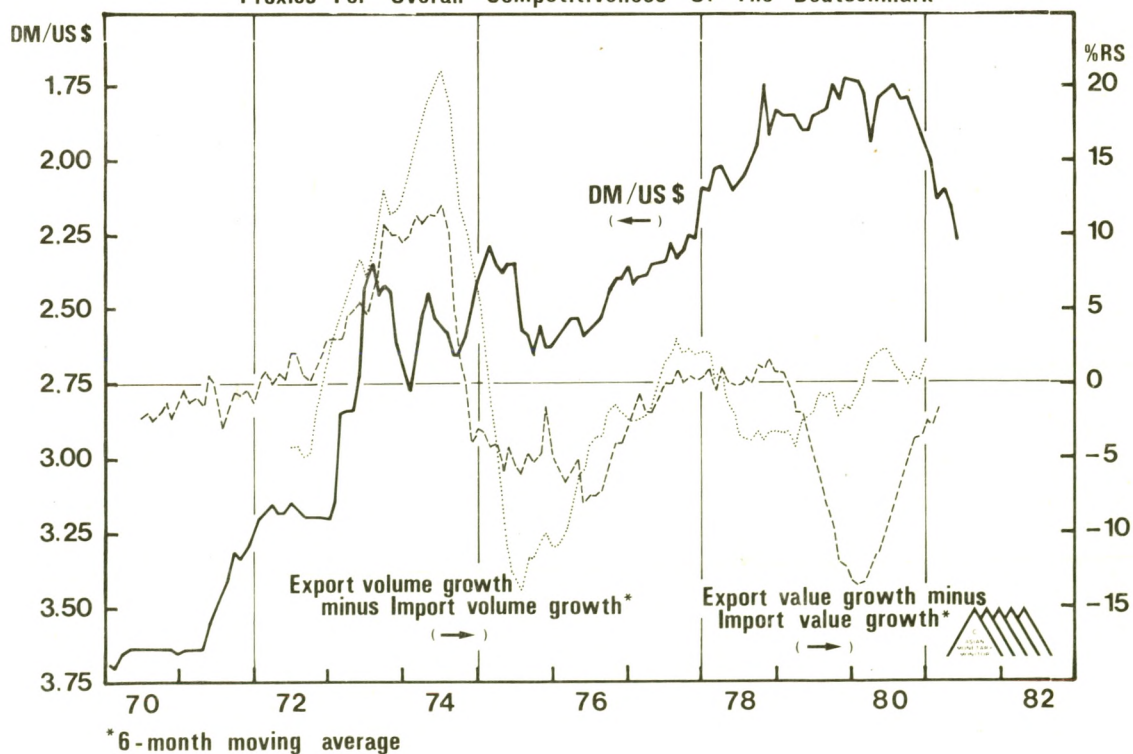
Before attempting to analyse why the West German currency reached this position it is important to outline Japan's basic economic experience during this period. The characteristics of Japanese economy in the wake of the second oil crisis were discussed at length in a recent edition of Asian Monetary Monitor (AMM Vol. 4 No. 5), but they are worth summarising briefly here. After 1973 there was a fundamental change in the Bank of Japan's monetary policy. The Bank of Japan abandoned its previous method of indirect control of the money supply through a pegged exchange rate and opted, instead, to exert direct control on the money supply whilst at the same time allowing the yen to float relatively freely on the foreign exchanges. In the latter half of the 1970s, the Bank of Japan maintained monetary growth at a stable, relatively low level. (Compare this period with previous episodes in Chart 1.)

This had two broad effects. First inflation, as measured by the GDP deflator and the consumer price index, remained at low levels after falling sharply in 1975 and 1976. Second, overall economic activity became more stable than before, as

Japan : Chart 5
Proxies For Overall Competitiveness Of The Yen



W.Germany : Chart 6
Proxies For Overall Competitiveness Of The Deutschmark



may be seen in the trend in Nominal GNP depicted in Chart 1. The domestic Japanese economy became much less cyclical than when the yen was pegged to the US dollar. Instead of allowing cyclical changes in the current account and balance of payments to be reflected in cyclical expansions and contractions in monetary growth, and hence in output and inflation the Bank of Japan was at pains to offset the impact of external inflows or outflows by varying its provision of reserves at the discount window. However a necessary consequence of the Bank of Japan's direct control over domestic monetary growth is that the yen has been allowed to become more cyclical/volatile. The Bank of Japan has been content to see large swings in the yen/dollar rate where this has proved necessary, or inevitable, as a consequence of relative inflation rates or external account pressures, in order to bring the Japanese economy into line with its major trading partners. In other words, the Bank of Japan has tolerated flexibility in individual prices (the exchange rate, import prices, wholesale prices) in its effort to secure low overall prices, and more stable real economic activity through steady control over the money supply. The results of this policy are highlighted in Chart 3.

Turning back to West Germany, we can view the economy's overall competitiveness - the driving force behind the trend in its business cycle - as being influenced by two fundamental factors. First, there is the actual level of the currency. The second important influence is the level of domestic aggregate demand relative to a country's trading partners. If we look back at the German economy in late 1978 it appears that, as with the yen, the German currency was in danger of becoming overvalued (observe the trend in exports relative to imports depicted in Chart 6). Part of the reason for this was undoubtedly the sharp rise in the Deutschemark during the preceding year, during which period it had appreciated by around 25% against the US dollar, a rise roughly equivalent to that recorded by the yen. However it seems that another important fundamental reason behind the weakening trend in West German competitiveness was the surge in monetary growth into the summer of 1978. From a year-on-year rate of growth of around 7½% in June 1977, the Bundesbank allowed M3 growth to accelerate to a peak of 11.4% in October 1978. With inflation relatively low, though rising, and interest rates declining up until the autumn of 1978, overall liquidity was very easy.

This was reflected in West Germany's industrial production which after having been sluggish in early 1978 started to expand quite rapidly towards the end of the year, and also in the surge in import growth lasting from the end of 1978 to the first quarter of 1980. In retrospect this move to substantially "easier" liquidity proved disastrous since it occurred just at the time when a) the Deutschemark was at a cyclical peak against the US dollar and b) during the period when the US authorities were initiating a policy of higher interest rates and lower monetary growth. In due course, the Bundesbank was forced to cut back on liquidity growth as inflationary pressures rose and as the West German economy's lack of overall competitiveness became apparent in the form of a deteriorating

trade and current account. From 11.2% in June 1979 the year-on-year rate of growth of M3 declined very sharply to less than 5% in mid-1980, whilst at the same time the Official Discount Rate was raised from 3% to 7½%. Nevertheless this severe monetary squeeze, which has produced the recession now visible in all sectors of the economy, occurred too late in the day to prevent further declines in West Germany's trade account. With the current account now firmly in deficit, the Deutschemark has proved particularly vulnerable to rising US interest rates.

This underlying reason for the West German economy's current weakness suggests that the important fundamental difference between the business cycles in West Germany and Japan lies in their respective monetary policies. During the period from 1976 to the present time there have been essentially four separate phases in the Bundesbank's monetary policy. These are outlined in the lower segment of Chart 4. West Germany's monetary experience in 1976 should be thought of as a continuation of the cyclical expansion which began in the third quarter of 1975. By June 1976 monetary growth had more than doubled from its trough in the second quarter of 1975. In the course of the following year the Bundesbank retrenched, cutting M3 growth back to the 7%-8% range by mid-1977. At that point the Bundesbank started the roller-coaster back in motion by cutting interest rates and following an aggressively expansionary monetary policy. Once again M3 growth rose sharply and remained in excess of 10% year-on-year until July 1979. It was only then that the Bundesbank entered upon the final stage of its erratic monetary policy. The recent squeeze brought M3 growth to its lowest level for a decade, and presaged the severe downturn in economic activity evident from the latter half of 1980 onwards.

In contrast, Japanese monetary experience during the last five years has been much more stable and this explains the relative stability of total Nominal GNP. After falling sharply from mid-1976 to June 1977, M2 growth in Japan was maintained in the 10%-13% range until July 1980. Given the higher real growth rate in Japan (about 5-6% p.a.), overall inflation in Japan remained low. (The GDP deflator - the difference between nominal and real GNP growth indicated in Chart 1 - fell to close to zero early in 1980.) Japan was thus able to allow the brunt of the 1979 oil price increase to be borne by a weaker yen without fear of aggravating domestic inflationary pressure. The Bundesbank could not risk this. The second oil crisis struck near the peak of a cyclical upswing in monetary growth at a time when overall inflation was rising and when the Deutschemark looked considerably overvalued. In retrospect it is easy to see that the Bundesbank had little choice but to engineer a recession.

Thus it appears that one key to the fundamental differences in the Japanese and West German business cycles lies in the more cyclical monetary policy adopted by the Bundesbank. However at first glance the Bundesbank's erratic monetary policy is somewhat surprising in view both of its stated objectives, and the techniques and monetary instruments which

the Bundesbank utilises. In December 1974 the Bundesbank affirmed that it would *"conduct monetary policy in such a way that the rate of price rises will progressively be diminished while at the same time the requisite monetary margin will be granted for the envisaged real growth of the economy".** The Bundesbank realised that with a floating exchange rate *"domestic monetary policy was better protected against external influences"* and that *"it was only logical for it (the Bundesbank) to pay more attention to the control of the money stock."***

In order to signal its monetary intentions the Bundesbank decided to announce specific, quantitative, monetary growth targets. It was the first central bank to introduce such measures. The quantitative target was to be applied to the Central Bank Money Stock, which is defined as currency in circulation plus required minimum reserves on domestic bank liabilities (calculated at seasonally adjusted constant reserve ratios on a January 1974 base date). Thus the Bundesbank instituted what was close to a monetary base method of monetary control. (The difference between control of the CBMS and the monetary base in West Germany is slight. Monetary base control would involve control over currency in circulation plus total reserves i.e. required reserves plus excess reserves. The Bundesbank's method only includes required reserves.) More importantly, reservable assets in West Germany consist of banks' balances at the Bundesbank. In other words, as is the case in Japan, the monetary base consists entirely of liabilities of the Bundesbank. Thus monetary control in both countries has not been unnecessarily complicated by the multiple reserve asset systems (which also include government liabilities) existing in countries such as the U.K.*** and Australia.

Two other crucial elements of the Bundesbank's post December 1974 monetary policy are also outlined in Herr Emminger's 1978 address. First, the Bundesbank would intervene *"when the foreign exchange markets are in turmoil"* for *"the central bank cannot expose the economy to the erratic movements resulting from speculation-induced exchange rate fluctuations without taking counter-measures"*. Nevertheless, *"foreign exchange interventions that are accompanied by an (unavoidable) upward movement of the Deutschemmark must be judged differently, in terms of stabilization policy, from foreign exchange interventions under a system of pegged exchange rates"*. Second, the Bundesbank originally undertook to neutralise the impact of cyclical changes in the external account account by adjusting domestic reserve requirements and undertaking open market operations.

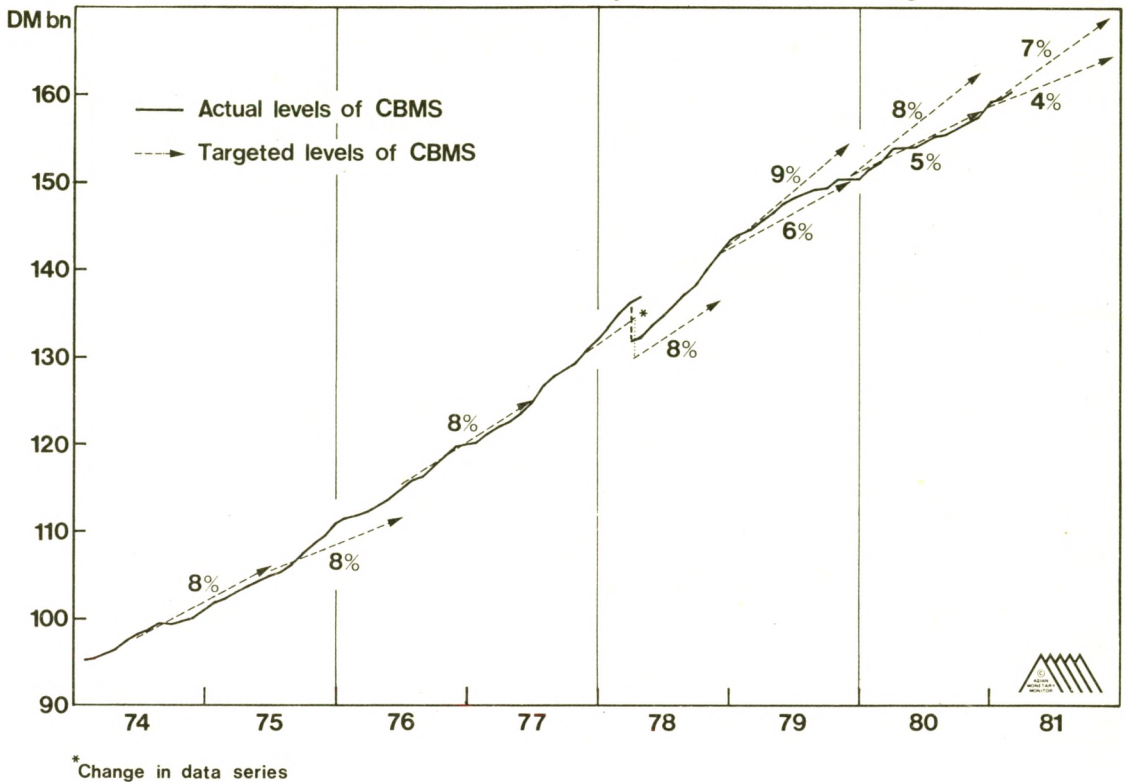
Thus it seems that, in theory, the Bundesbank sought to conduct monetary policy in a similar way to the Bank of Japan. With its array of monetary instruments - principally open market operations, discount rate changes, and alterations in

* Reprinted in an address given by Herr Emminger, then President of the Bundesbank, in the Monthly Report of the Deutsche Bundesbank Vol. 30 No. 6, June 1978, page 9.

** *ibid*, page 10.

*** The important differences between the Japanese and UK banking systems were discussed in AMM Nov.-Dec. 1979 Vol. 3 No. 6.

W. Germany: Chart 7
Growth Of Central Bank Money Stock Relative To Target



(sensibly defined) reserve ratios - the Bundesbank has been technically equipped to achieve the appropriate monetary target - control of the money supply, not control over a particular interest rate - in a way that is reliably designed to produce lower overall inflation and a relatively stable level of domestic economic activity.

Nevertheless, as illustrated in Chart 7, the Bundesbank has apparently found it difficult to attain its monetary targets. In three of the last six years, CBMS growth has exceeded its published target. In 1975-76 and 1976-77, when the CBMS target was a single figure rather than a range as now, CBMS growth was only slightly in excess of the desired level in spite of wider fluctuations within each year. However the 1977-78 CBMS target was exceeded by a wide margin. The Bundesbank had aimed for a rise of 8% in the CBMS from the fourth quarter of 1977 to the last quarter of 1978 but in the event the CBMS spurted 11.3%. The Bundesbank's relative lack of success in reaching its monetary targets during crucial stages of the business cycle, has led to quite large fluctuations in monetary growth and this has not been conducive to the progressive decline in inflation which the Bundesbank had intended.

It is therefore crucial to try to explain why the Bundesbank has allowed monetary growth to fluctuate over relatively wide ranges when it has been technically equipped to pursue stable growth in the monetary aggregates, and where this

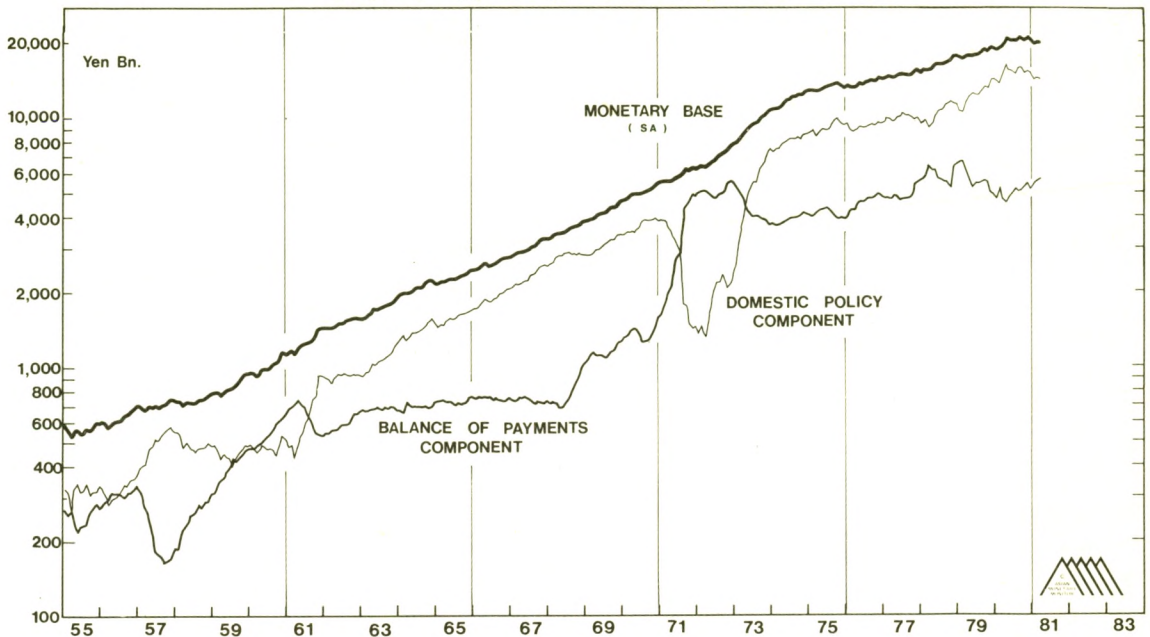
ability appears to be consistent with its domestic economic objectives. The answer to this, which is central to the fundamental differences between the Japanese and West German business cycles, lies in a combination of two related factors. First, the Bundesbank has not, in fact, successfully managed to insulate monetary growth from the cyclical movements in West Germany's current account. Second, the Bundesbank has found itself exposed to the generally inconsistent objective of attempting to follow a domestic monetary growth target whilst simultaneously pursuing the independent exchange rate objectives implied by the Deutschemark's membership of the European Monetary System.

Chart 10 indicates that over the past six years there has been close relationship between the cyclical trend in West Germany's current account and monetary growth as measured by M3. This relationship is in marked contrast to Japan where monetary growth has been much more independent from Japan's overall external position (see Chart 3). Charts 8, 9, 10 and 11 examine the basis for these relationships from the point of view of the sources of the CBMS growth in West Germany and the monetary base in Japan.

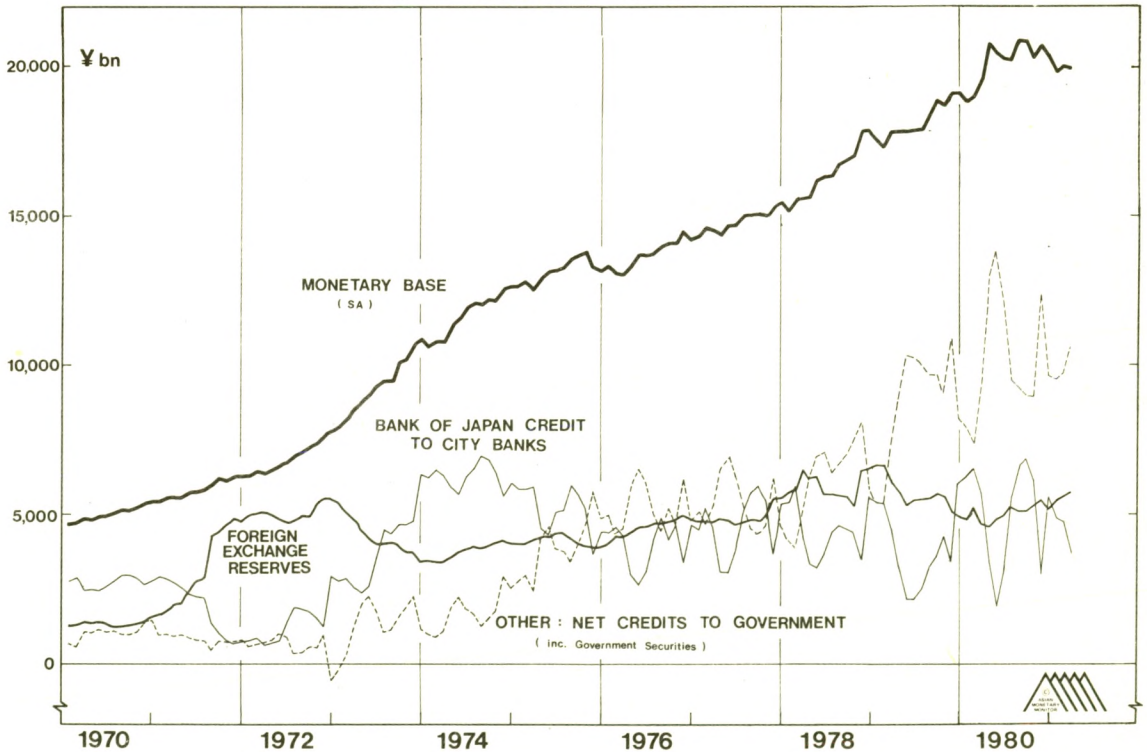
It is clear from Charts 8 and 9 that during the 1977-1980 period, when Japan's trade and current accounts underwent rapid cyclical changes, that the Bank of Japan successfully avoided the mistakes it had made during 1972-73. In the earlier period Japan's growing current account surplus coupled with diminished confidence in the US dollar had generated sharp upward pressure on the yen-US dollar rate. At that time the Bank of Japan attempted to support the US dollar by selling yen. These operations were associated with very large increases in Japan's foreign exchange reserves and an acceleration in monetary growth. By 1977 and 1978, however, when the US dollar was once again experiencing downward pressure on the foreign exchanges the Bank of Japan's policy had evolved in two crucial ways. First, as we have experienced previously, the Bank of Japan allowed the yen to float relatively freely against the US dollar and it did not try to pursue any specific exchange rate target. Second the Bank of Japan offset most of the increase in the balance of payments component of the monetary base (a rise which occurred because of both the current account surplus and occasional, temporary, foreign exchange interventions) by reductions in both credit to the banking system and credits to the government. Similarly the fall in the balance of payments component of the monetary base as Japan's current account declined in 1979 was also offset by an increase in credit to the domestic economy. As is evident in Chart 9 this was mainly in the form of an increase in the Bank of Japan's holdings of government debt. The net result of these operations was that the growth of the monetary base was relatively stable in the period from 1976 to 1980.

The Bundesbank's experience during this period was markedly different. Chart 10 illustrates that the combination of West Germany's favourable current account position and the

JAPAN
CHART 8 : MONETARY BASE AND COMPONENTS

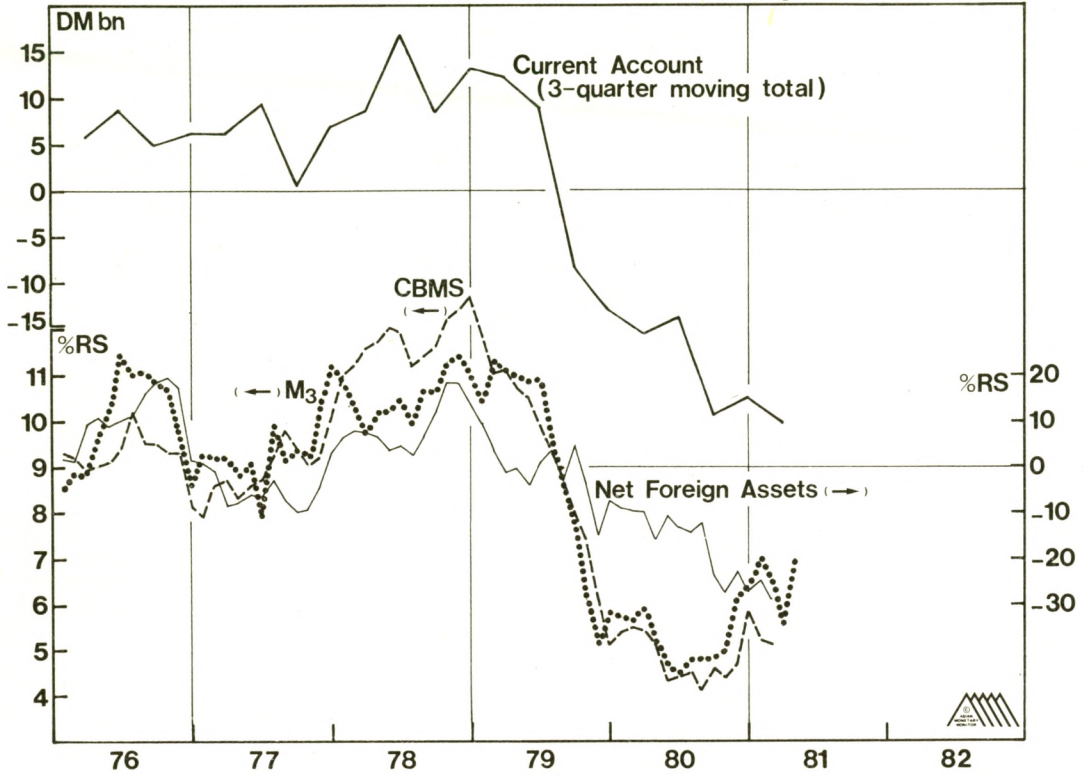


JAPAN
CHART 9 : SOURCES OF THE MONETARY BASE

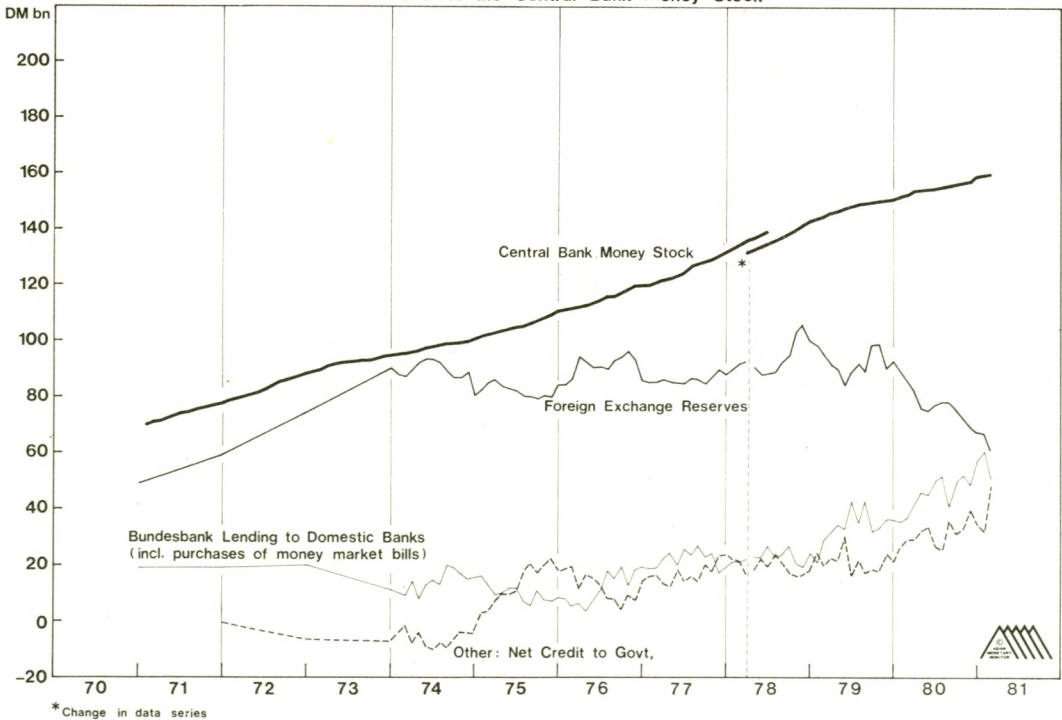


W. Germany: Chart 10

The Current Account, Changes in the Central Bank Money Stock,
Net Foreign Assets of the Bundesbank and M₃



W. Germany: Chart 11
Sources of the Central Bank Money Stock



* Change in data series

Bundesbank's frequent foreign exchange market interventions during 1976 and again in 1978 led to sharp increases in the Bundesbank's net foreign assets which helped stimulate an acceleration of CBMS growth and hence M3 growth. There are two important points to note here. First Charts 10 and 11 indicate that unlike the Bank of Japan, and at variance to its stated intent, the Bundesbank has not successfully offset cyclical changes in the external account so as to encourage smooth and stable growth in the monetary aggregates. This is particularly evident in the period from the second half of 1979 to the end of 1980. Second, especially during the crucial period during the second half of 1978, the Bundesbank intervened in the foreign exchange markets to sell Deutschemarks even though it was well aware that CBMS growth was in excess of the targeted range. The reason that this occurred is explained in the December 1978 Monthly Report of the Deutsche Bundesbank, and we feel that this is worth quoting at length since it provides a crucial component in analysing the fundamental differences between the Japanese and West German business cycles.

"This (i.e. CBMS growth in excess of its target level during 1978) arose mainly because of developments in the foreign exchange markets. In the summer new tensions had arisen within the European narrower margins arrangement. As a consequence, the currencies of partner countries increasingly had to be supported using Deutschemarks. Between July and mid-October these interventions resulted in an inflow of foreign exchange to the Bundesbank totalling about DM 10 billion. Not until exchange rates in the European narrower margins arrangement were realigned on October 16 could the situation be remedied. But conditions deteriorated sharply again in the second half of October, when the US dollar came under heavy pressure in the exchange markets. Not even the measures taken in the energy field and the anti-inflation programme adopted by the US Administration sufficed to stop the decline in the US currency, which was caused by a deep-rooted loss of confidence. The culmination of this development was that the rate of the dollar fell to a new all-time low of DM 1.73 towards the end of October. Under the impact of these events the US Administration, assisted by the central banks of a number of hard-currency countries including the Federal Republic of Germany, approved a comprehensive support programme at the beginning of November. The dollar responded to this programme and to the exchange market interventions which the programme made possible by recovering strongly. Although some foreign exchange flowed out from the Bundesbank once conditions had settled down, the increase in the monetary reserves during the latest monetary disturbances (i.e. between the beginning of August and the end of November) amounted to some DM 17 billion; this is far more than would have been compatible in normal circumstances with a policy aimed at containing the growth of the money stock."*

In other words, the Bundesbank found it impossible to achieve both its domestic monetary targets and its external foreign exchange objectives. During the last half of 1978 the Bundesbank's foreign exchange intervention indicates an effort to maintain the Deutschemark at an artificially low level relative to both its partners in the EMS and the US dollar. The natural corollary of this was rising monetary growth that presaged a boom in the domestic economy during 1979 and the

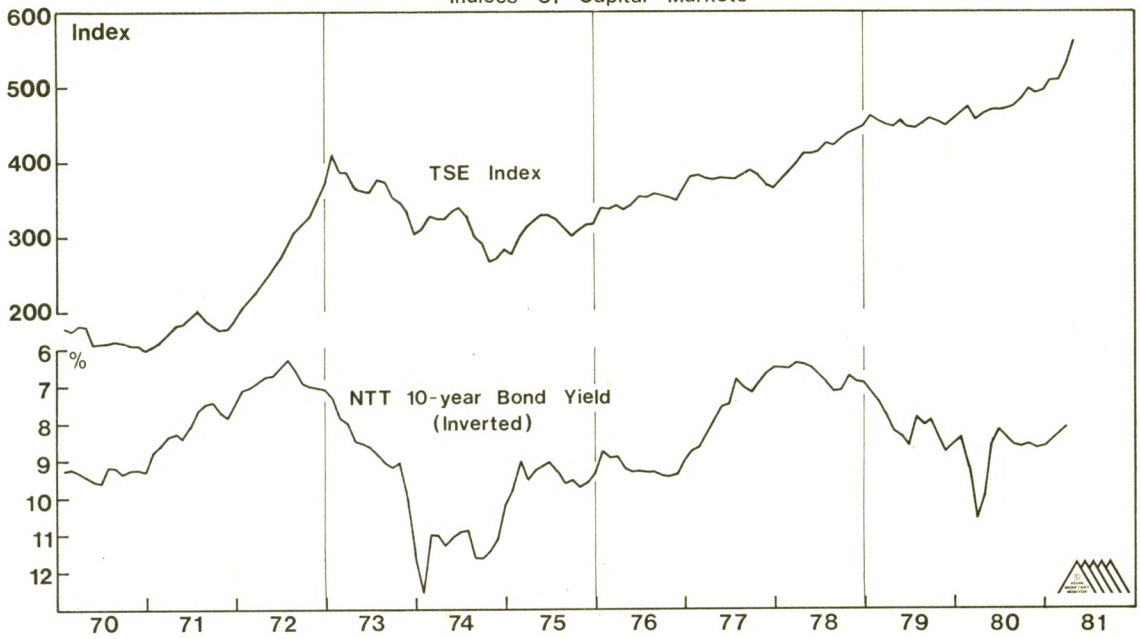
* This is reflected in Chart 10.

first quarter of 1980. Precisely the opposite phenomenon occurred during the first quarter of 1980 and again in the autumn of that year. The Bundesbank entered the foreign exchange market to sell US dollars in an attempt to limit the Deutschemmark's weakness and to prevent a rise in domestic consumer prices as a consequence of higher import costs. The Bundesbank during these periods was trying to maintain the Deutschemmark at an artificially high level with the result that monetary growth declined. This gave rise to a marked slowdown in economic activity.

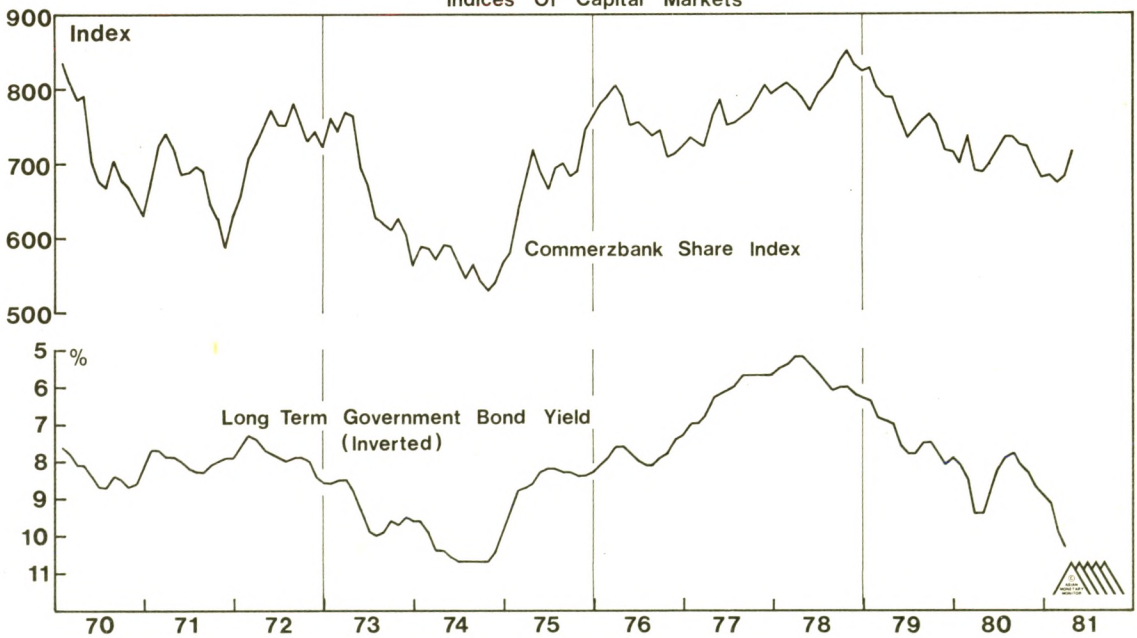
We can now summarise the different transmission mechanisms of monetary policy in both West Germany and Japan in order to illustrate the fundamental contrasts in their economies' business cycles. The Bank of Japan has followed a policy of stable, low, monetary growth. To achieve this it has allowed greater flexibility in domestic interest rates and has permitted large cyclical movements in the yen's exchange rate following cyclical fluctuations in Japan's external account. The Bank of Japan has not followed any specific foreign exchange or external account targets. The cyclical swings in Japan's current account and balance of payments have induced pressure for wider fluctuations in domestic monetary growth, but the Bank of Japan has successfully offset most of these in order to achieve more stable monetary growth. The large changes in the strength of the yen on the foreign exchanges have created very rapid changes in import prices (up 83.5% at their peak in March 1980) and wholesale prices (see Chart 3) but the low rate of monetary growth relative to domestic aggregate demand prevented this from percolating through into domestic wage-cost inflation. Thus relative prices (of the yen, imports, exports and credit) fluctuated over a wide range but overall inflation remained very moderate. The GDP deflator, which is the widest measure of domestic inflation, rose a mere 1.1% in the year to June 1980. The cyclical changes in relative prices encouraged major shifts in the composition of GNP in Japan which enabled the economy to adapt exceptionally quickly to important external changes such as the yen's relative lack of competitiveness in the autumn of 1978 and the OPEC price rises in 1979-80, whilst at the same time relatively stable monetary growth enhanced a smooth trend in total nominal GNP. In other words, the distinctive characteristic of Japan's business cycle over the last five years has been adjustment primarily through cyclical changes in relative prices, rather than in the level of overall economic activity.

The transmission mechanism of monetary policy in West Germany could have been very similar to that of Japan, and indeed until the end of 1978, many commentators viewed the two economies in the same light. The Deutschemmark's formal peg to the US dollar has been abandoned, and the Bundesbank is technically equipped to promote smooth monetary growth. Nevertheless, the West German authorities have at various times insisted on attempting simultaneously to pursue external goals related to the level of the Deutschemmark against both the US dollar and other currencies within the European Monetary System. The effect of this has been to increase the dependence

JAPAN: CHART 12
Indices Of Capital Markets



W. GERMANY: CHART 13
Indices Of Capital Markets



of monetary growth on the West German current account (see Chart 8). Monetary growth in West Germany has therefore not been effectively independent of the overall competitiveness of the Deutschemmark and the level of world economic activity. This is in striking contrast to monetary policy in Japan. As a result of its external objectives, the Bundesbank, unlike the Bank of Japan, has been less successful in insulating the level of domestic economic activity in West Germany from that in the rest of the world, especially the US. Fluctuations in the external account have been unnecessarily reflected in fluctuations in West Germany's nominal output and growth. Moreover, the swings in West Germany's business cycle have been amplified by the Bundesbank's concern to limit consumer price inflation. Thus in December 1978 the Bundesbank reported that: *"Up to now the Bundesbank has been able to tolerate the very strong expansion of the money in the hands of residents in so far as the movement of the exchange rate of the Deutschemmark has automatically tended to slow down the rise in domestic prices and costs. But the more success is achieved in stabilising exchange rates - the more necessary it will be for monetary policy to consider and take account of the possible domestic consequences of an excessive expansion of the money stock and the other monetary aggregates."* (Our emphasis). In other words, the Bundesbank's monetary policy has tended to be pro-cyclical, moving more or less in line with the strength of the Deutschemmark. This has amplified fluctuations in the level of domestic economic activity.

A further point should be noted. The West German authorities' foreign exchange objectives has tended to dampen the operation of the price mechanism in promoting important structural change. For example, the Bundesbank's attempt to maintain a firm Deutschemmark - US dollar rate in 1980, would undoubtedly, if it had been successful, have reduced imported costs, but it also reduced the incentive to shift away from the consumption of higher priced imports, particularly oil. The Bundesbank's Deutschemmark support operations also tended to exacerbate the duration of West Germany's current deficit, at the cost of a prolonged squeeze on the domestic economy. As a direct consequence, of the Bundesbank's foreign exchange and monetary policy the adjustment process in the West German business cycle has been as much in terms of changes in the absolute level of economic activity as in changes in the relative price of output and consumption.

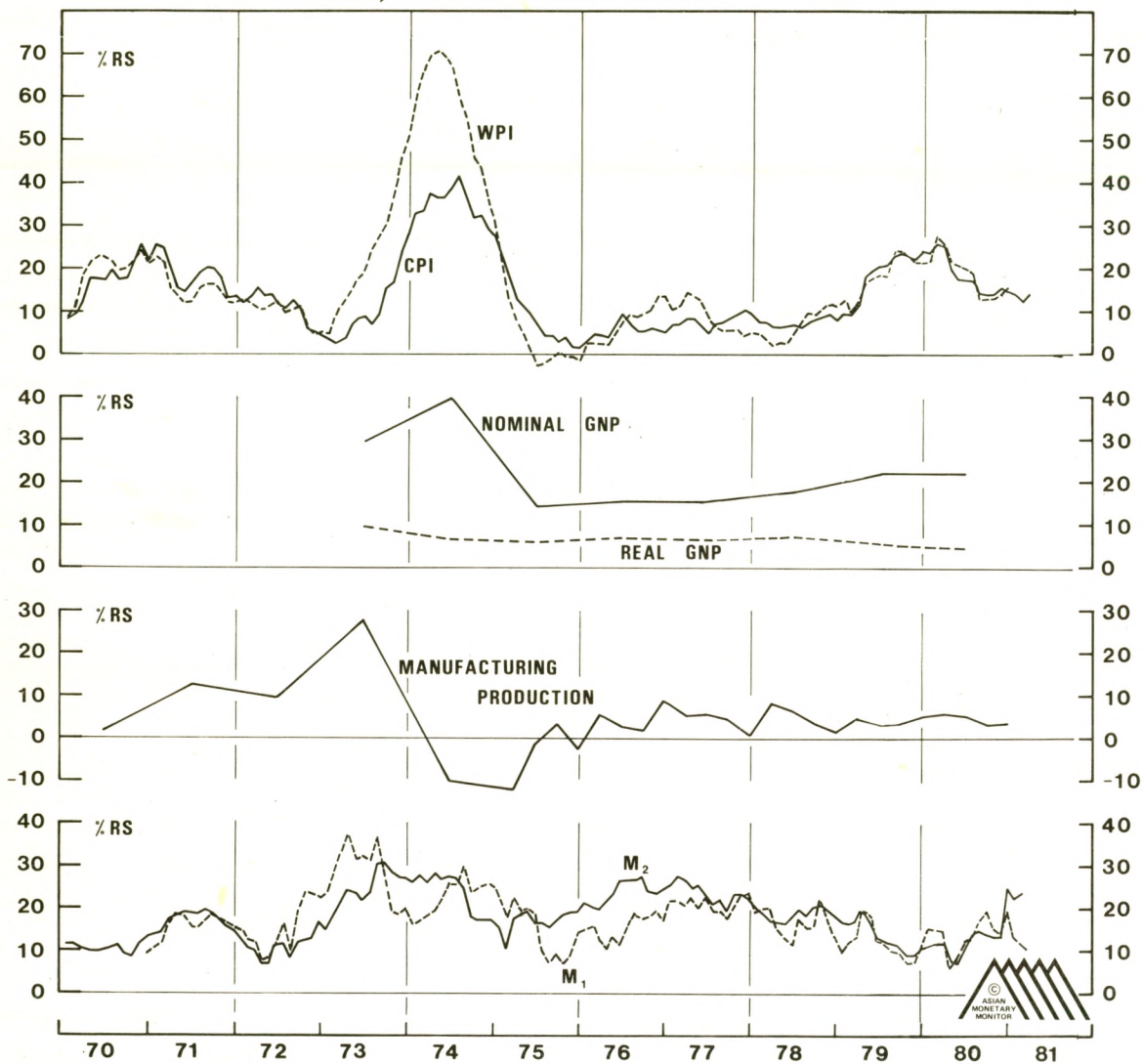
FORECAST: So long as the Bundesbank continues to pursue external foreign exchange objectives, the West German economy will remain more cyclical than Japan's, and more closely dependent on economic activity and interest rates in the US. This will remain true irrespective of any changes in the size of the fiscal deficit in both countries, their dependence on oil imports, or the relative "openness" of their economies. In general, central banks may choose between cyclical fluctuations in their currencies and relatively stable levels of overall domestic inflation and Nominal GNP. To the extent that they intervene in the foreign exchange market or allow trends in their economies' external accounts to be reflected in monetary

growth, cyclical fluctuations in their exchange rate will tend to be reduced at the expense of a more volatile domestic economy. This has been the course adopted by the Bundesbank.

The current recession in West Germany and the weakness of the Deutschemmark should not be interpreted as evidence of a secular change in either the productiveness of the economy or the likely strength of the currency. They are primarily a product of the type of business cycle which the Bundesbank has chosen to implement. Thus although the present downturn in the economy has been, to most observers, surprisingly severe most of the ingredients for the next cyclical recovery are now in place. The most important of these is the emerging competitiveness of the Deutschemmark (see Chart 6), after its weakness during the past year, at a time when liquidity in the domestic economy has in all likelihood reached a cyclical trough. It is probable that as in 1975 and 1976 a recovery in real output will be accompanied simultaneously by a stronger Deutschemmark, an improved external account, lower interest rates and an acceleration in monetary growth. In due course this will be reflected in a sharp recovery in all sectors of the West German equity market.

This is in contrast to the recovery in real output due shortly in the Japanese economy. For in Japan all of the financial, or relative price, indicators have already recorded a substantial improvement from the troughs of April 1980. Consumer and wholesale price inflation has declined, as have interest rates, and the yen's appreciation has reflected the recovery in the trade and current account. Thus real output and relative price changes will once again prove not to be synchronised. This was a characteristic of the Japanese economy in 1977-78 when the recovery in output also lagged an improvement in the yen, inflation and interest rates, and in 1979 when output continued firm in the face of adverse financial indicators. This characteristic of the Japanese economy is a result of the type of business cycle the Bank of Japan has chosen to impose. It reflects the fact that, unlike the Bundesbank, the Bank of Japan designs its monetary policy such that the brunt of cyclical adaptations implied by the business cycle take the form of changes in relative prices rather than changes in the absolute level of economic activity.

**CHART 1
PHILIPPINES
MONEY, OUTPUT AND PRICES**



PHILIPPINES

THE NEW GOVERNOR FACES TWO CRISES

In recent years the Philippines seems to have had more than its share of financial scandals. In 1976 there was the saga of Oriental Petroleum whose share price halved in a single day when it was revealed that the company's oil revenues would fall far short of previous estimates. In 1979 Agrix, Santamaria and Manotoc Securities went down, and so far in 1981 three securities companies - Pascual Securities, Bridgestone Securities and Makati Securities - have had their operations on the Makati Stock Exchange suspended. Volume on the stock exchanges has slipped to all time lows. On the banking scene a stream of small rural banks - about 30 in all - went under during 1980, and one of Pacific Banking Corporation's loan officers absconded with ₱30 million of a client's funds. On January 9th there was a run on Consolidated Bank and Trust Co. Then finally the country's financial markets have been rocked by the disappearance on the same day of Dewey Dee, president of the Continental Manufacturing Corp. who left behind him unpaid debts reported to be in excess of ₱580 million (US\$74 million), mainly in commercial paper.

This was the gloomy financial scene inherited by Jaime C. Laya on January 14th 1981 when he took over as the fifth Governor of the Central Bank replacing the venerable Gregario S. Licaros, a man who had been in government service for 50 years. Mr. Laya was transferred from his office in the Presidential Palace where he had been Minister for the Budget, but he had previously been at the Central Bank between 1974 and 1978 when he was responsible for banking supervision and examination so he is a man with experience of both central banking and government finances. The situation he faced was not at all comfortable for not only were numerous financial institutions in difficulty following the events of early January, but on the broader scene the country is still experiencing considerable problems in adjusting to the external disturbances of 1979-80 and in achieving any measure of domestic stability.

The immediate task that faced Mr. Laya was the crisis in the financial markets. The longer term task facing him is the problem of adjusting the economy to its changed financial circumstances.

(A) THE SHORT TERM CRISIS OF CONFIDENCE

The crisis of confidence in the financial markets required a prompt programme of action, and Mr. Laya has been quick to respond to the challenge. A four-part programme was initiated between February 4th and February 16th consisting of the following measures:

- (1) An emergency Fund was created to assist not only banks but also non-bank private companies affected by the crisis.

Starting at ₱1.5 billion the fund is due to be expanded to as much as ₱5 billion over some time. These funds were to be distributed by the Central Bank through the Philippine National Bank and the Development Bank of the Philippines, both quasi government banks, at rates far below the going money market rates. With 60-day money costing as much as 24%, the new fund made money available at 11% to the banks who could then pass the funds on at a 2.5% spread when lending to companies. The purpose of this fund was to cope with premature withdrawal of funds from the money market - so-called pre-terminations - and the reluctance of lenders to roll over existing loans.

On the one hand the government would make new funds available to those companies which were severely stretched; on the other hand a scheme was devised to absorb some of the liquidity of those organizations unwilling to deploy their funds in the commercial paper market during the period of crisis. Accordingly an announcement was made to the effect that the authorities would hold 8 successive weekly auctions of Central Bank Certificates of Indebtedness (CBCIs) amounting to ₱150 m on each occasion. The idea was that firms or individuals with large-scale sums would be willing to buy these safe, relatively high-yielding instruments which were guaranteed by the government. Obviously the proceeds could be channelled back to the original cash-starved borrowers through the new Emergency Fund. In effect by acting as an intermediary the government has shouldered the risk of these loans, at a cost equal to the difference between the rates that it has had to pay to raise the funds in the open market and the 11% rate charged to the PNB and DBP.

In fact only six of the eight planned auctions were actually held because the bid-level of yields at these auctions rapidly returned to market levels i.e. above the rates the authorities were willing to pay to bale out casualties of the Dewey Dee affair.

- (2) A new "Information Center" was set up. All banks and finance companies are now obliged to report all loans to the Center including terms, maturity etc.
- (3) Stricter criteria were introduced for the issue of commercial paper. Certain issues already outstanding were suspended in an attempt to raise the average quality of existing issues. The Monetary Board of the Central Bank was empowered to set ceilings on commercial paper issues while the Securities and Exchange Commission will register all issues and obtain regular returns on their sales and on trading from issuers and dealers.
- (4) A Presidential Decree authorised the Monetary Board of the Central Bank to allow certain exceptions to the rule of strict confidentiality for bank customers. In cases of suspected bank fraud, for example, the ownership of bank

deposits and the underlying ownership of government bonds held at banks could be examined. Simultaneously the Monetary Board assumed full control over any banking institutions facing insolvency. The Central Bank was authorised by a separate Presidential Decree to appoint in addition to CB officials any persons of recognised competence in banking as receivers of the assets and liabilities of such institutions.

The repercussions of the events of January and early February have been far-reaching. Several well-respected investment houses have been subject to liquidity pressures, and a number of mergers and/or capital reorganisations can be expected. The larger banks - especially those licensed as "Universal Banks" or Unibanks in the local jargon - are likely to absorb some of their weaker brethren. Several stock-broking houses have been put into liquidation, though this owes something to the imposition of a capital gains tax last November which, in conjunction with the weak trend in most mineral prices and the generally unfavourable credit environment, has contributed to a dismally low level of activity on the stock exchanges.

There can be little doubt that the creation of the Emergency Fund has helped to alleviate the atmosphere of crisis and has contributed to the restoration of more normal conditions in the credit markets. For this the new Central Bank Governor deserves much credit. However, one must have serious doubts as to the wisdom of the other three components of the emergency programme, and as to the desirability of maintaining the fund in existence. In principle emergency measures are best dismantled soon after the emergency is over. The dangers in this case are that (1) a large-scale subsidy programme has been introduced and will continue in existence, (2) an unnecessary government bureaucracy designed to monitor all credit risks is superimposed on the banking system whose job is to take these risks in any case, (3) the growth of the commercial paper market as a cheaper method of funding will be hampered by unduly onerous requirements as to an issuer's "quality", and (4) greater and perhaps permanent participation by government officials in private financial institutions.

The extension of the bureaucratic hand of government in the aftermath of a crisis is unfortunately characteristic of many economies in recent years. In the case of the Philippines there have been frequent examples of a set of ad hoc measures - e.g. commodity price controls - to deal with a temporary situation becoming a permanent feature of the regulatory environment with resulting effects that are damaging to economic incentives and hence to economic growth in the longer term.

LETTER OF INSTRUCTION

TO: Governor of the Central Bank
Chairman of the Securities and
Exchange Commission
Chairman of the Development Bank
of the Philippines
President of the Philippine National Bank
The Minister of the Budget
All Others Concerned

FROM: President Ferdinand E. Marcos

DATE: February 15, 1981

Whereas, weaknesses of the Philippine money market have been identified in the wake of recent failures of certain corporate borrowers;

Whereas, credit decisions are made basically by banks and other financial institutions and lenders on the basis of information available to them;

Whereas, it is necessary to systematically assess the financial requirements and condition of major Philippine industries;

Now, therefore, I, Ferdinand E. Marcos, President of the Philippines, do hereby Order and Instruct:

1. The Central Bank of the Philippines shall extend full support to banks and other financial institutions meeting with temporary liquidity problems and shall implement the lender of the last resort facility authorized under the law;
2. A credit information exchange system shall be initiated by the Central Bank of the Philippines, which shall provide data on bank borrowings, commercial paper issuances and other forms of borrowing, to banks and other financial institutions. The data shall be obtained from financial

institutions and shall be released on an exchange arrangement, after the appropriate summarization and classification of data;

3. The Central Bank shall study the possibility of a credit bureau, in coordination with investment houses and other financial institutions, along the lines of similar bureaus abroad. If necessary, the Central Bank may subsidize the operations of such a credit bureau, which may be a local office of an established international institution;

4. The Central Bank shall require that financial institutions make available information on commercial paper sold without recourse and on placements of trust funds, to such extent as may be necessary to guard against concentration of credit in undue proportions;

5. The Securities and Exchange Commission shall review/revise existing guidelines and policies on the registration of commercial paper issues, with the aim of eliminating the issuance of commercial paper by non-creditworthy companies. It shall likewise improve the monitoring of financial condition of companies issuing commercial paper and shall reduce/cancel authorities to issue paper depending on the financial condition of such companies;

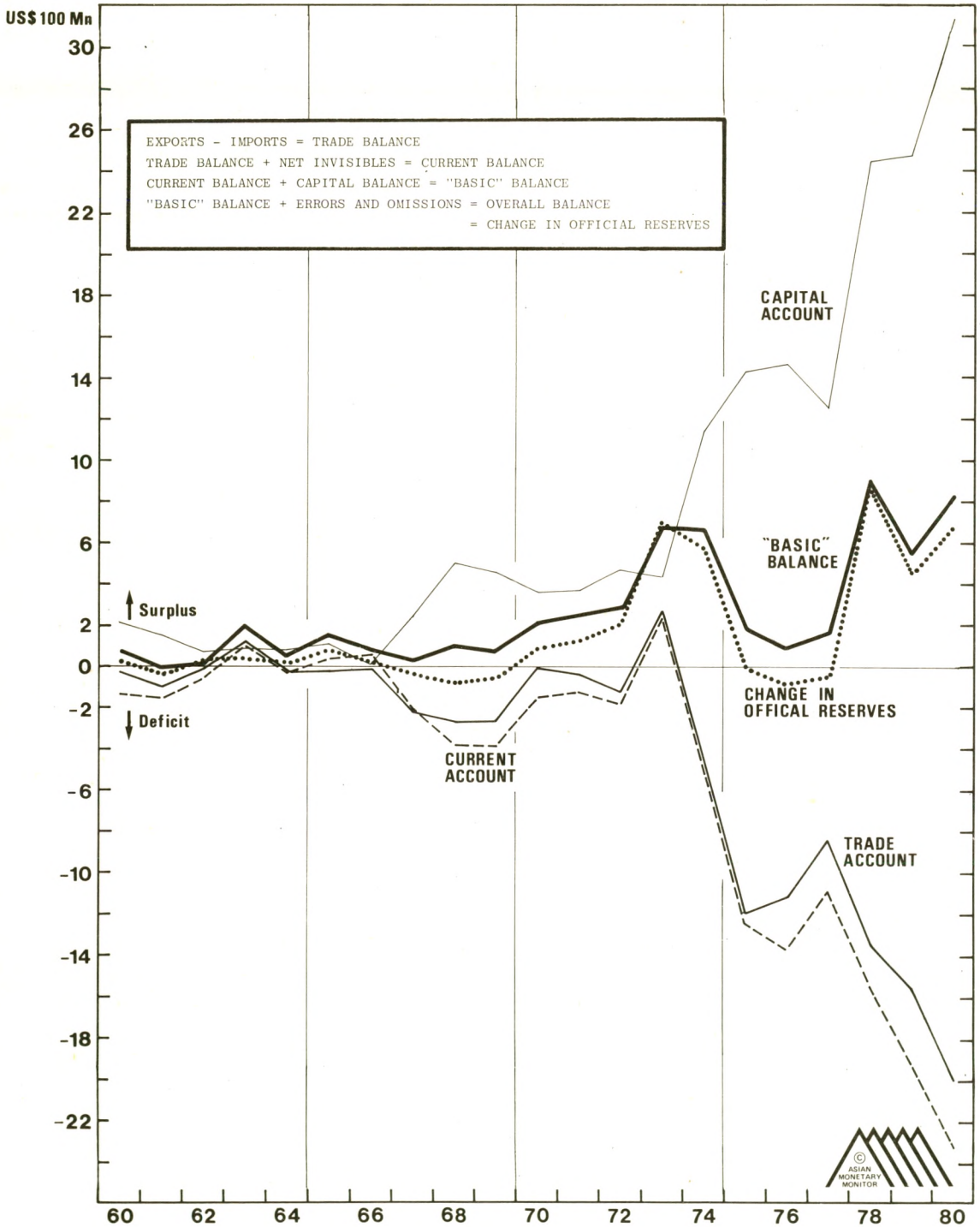
6. The Securities and Exchange Commission shall study and recommend to the President, policies and procedures relative to the suspension of trading in commercial paper of companies when conditions warrant. It shall study, in particular, the possibility of automatic suspension of trading in commercial paper when the issuing company defaults on a scheduled payment;

7. The Securities and Exchange Commission and the Central Bank of the Philippines shall coordinate with each other on the companies authorized to issue commercial paper, the maximum amounts authorized to be issued in each case, and related matters;

8. The Central Bank of the Philippines, the Securities and Exchange Commission, the Development Bank of the Philippines and the Philippine National Bank shall assess the financial condition of major borrowers on the money market, for the purpose of determining the need of instituting an industrial financing program that will assist priority industries in the rationalization of their finances. Such a program shall be organized with a budgetary contribution as seed fund, in the total amount of ₱1 billion which shall be released in phases in accordance with a schedule approved by the President on recommendation of the Minister of the Budget;

9. The Professional Regulation Commission shall see to it that Certified Public Accountants auditing the books of commercial paper issuers comply with the highest standards of the auditing profession and shall adopt such disciplinary measures as may be found appropriate in cases where misrepresentations exist in the audited/published financial statements.

PHILIPPINES
CHART 2: BALANCE OF PAYMENTS



(B) THE LONGER TERM CRISIS IN THE ECONOMY

The longer term task facing the new Central Bank Governor is even more challenging than the crisis of confidence which he faced in the early days of his Governorship. The Philippines was less successful than many other South East Asian or Far Eastern economies in adapting to the first oil crisis of 1974-75, and there is some danger that the Philippines' response to the second series of oil price hikes of 1979-80 turns out to be equally unsuccessful. The evidence for the relative lack of success in adapting to higher oil prices may be seen primarily in the continuous deterioration of the trade and current accounts (see Chart 2) in 1978, 1979 and 1980. This is also reflected in the gap which opened up between imports and exports in 1974, and which has never significantly narrowed. The overall balance of payments has however been shored up by very large foreign borrowings which are the major component of the capital account surplus in Chart 2.

The balance of payments of course only describes flows. The counterpart of the capital account surplus is a growing volume of overseas debt, much of it reflected in the foreign liabilities recorded on the balance sheet of the Central Bank. The Philippines' published figures for international reserves do not take into account these foreign liabilities since they record only the gross foreign assets, not the net foreign assets. As depicted in Chart 3 the net position has been deteriorating since mid-1978, and yet the monetary base has been pumped up by means of domestic expansionary measures. In the past a decline in the balance of payments component of the monetary base to zero or below zero has always been associated with a severe balance of payments crisis which has either been fended off temporarily by additional foreign borrowings, or has been solved by a devaluation (as in 1962 and 1970). It is clear from Chart 4 that the Philippines now faces such a crisis once again.

The basic cause of the crisis is not, in our view, to be blamed on external factors such as the oil price increases or the general slowdown in the growth of world trade. These are facts which every economy has had to face, and some economies like Japan and Singapore have surmounted these difficulties even though they have no domestic supplies of oil (whereas the Philippines does). The origins of the crisis are rather to be found in the apparent reluctance of the Philippine authorities to adhere to the discipline of the external balance of payments in implementing their domestic monetary and fiscal policies. In the words of President Marcos: "We are a developing country. We cannot afford traditional, orthodox financial policies."

Chart 5 shows that from mid-1972 to 1975/76 the pattern of monetary growth was essentially determined by the change in the net external position. A growing net foreign asset position translated into an accelerating money growth rate, and, after the level of net foreign assets peaked out, money growth slowed down. In the 1976-79 cycle of money growth there was a looser relation between net foreign assets and monetary growth, with

PHILIPPINES
CHART 3 : MONETARY BASE AND COMPONENTS

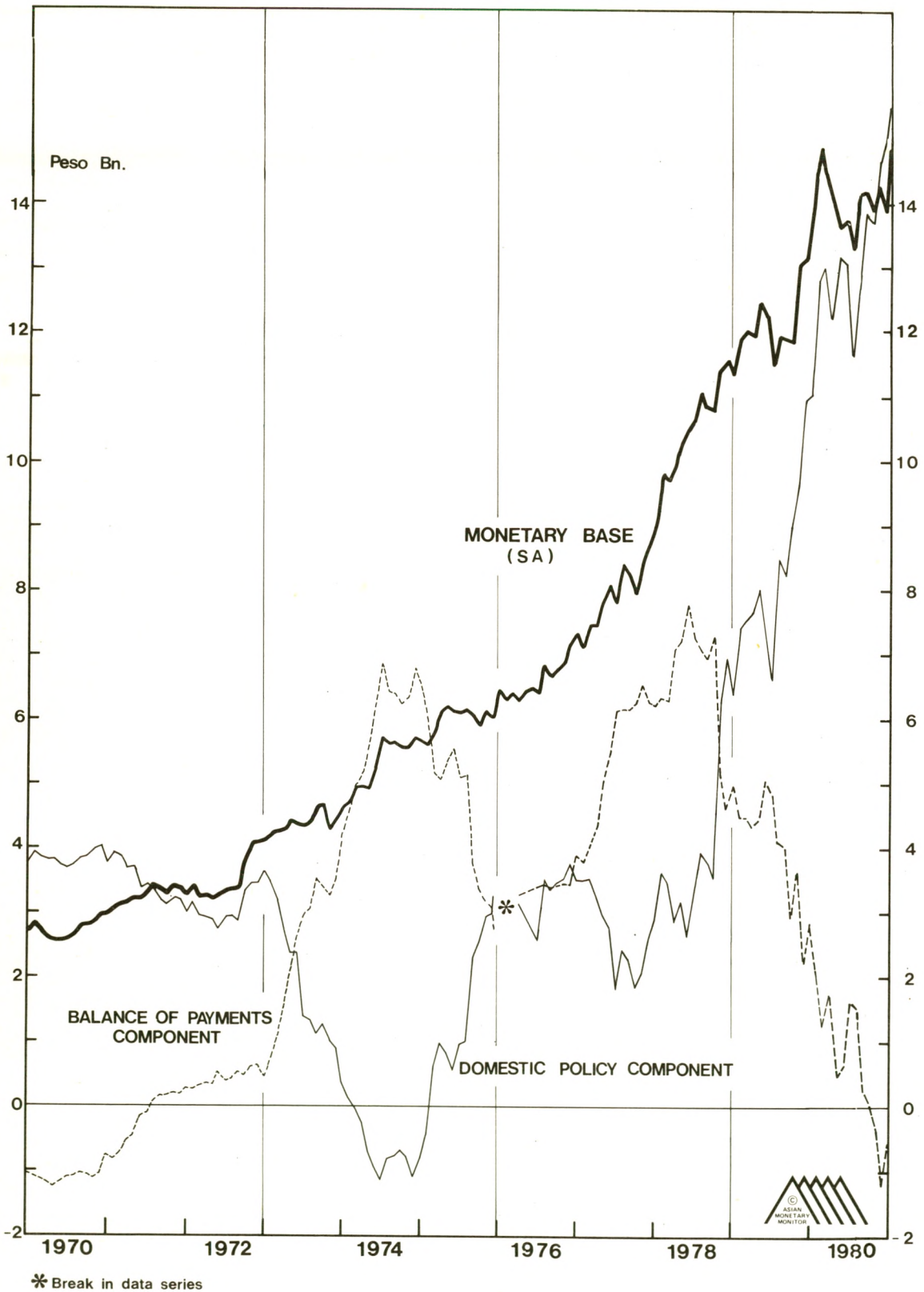
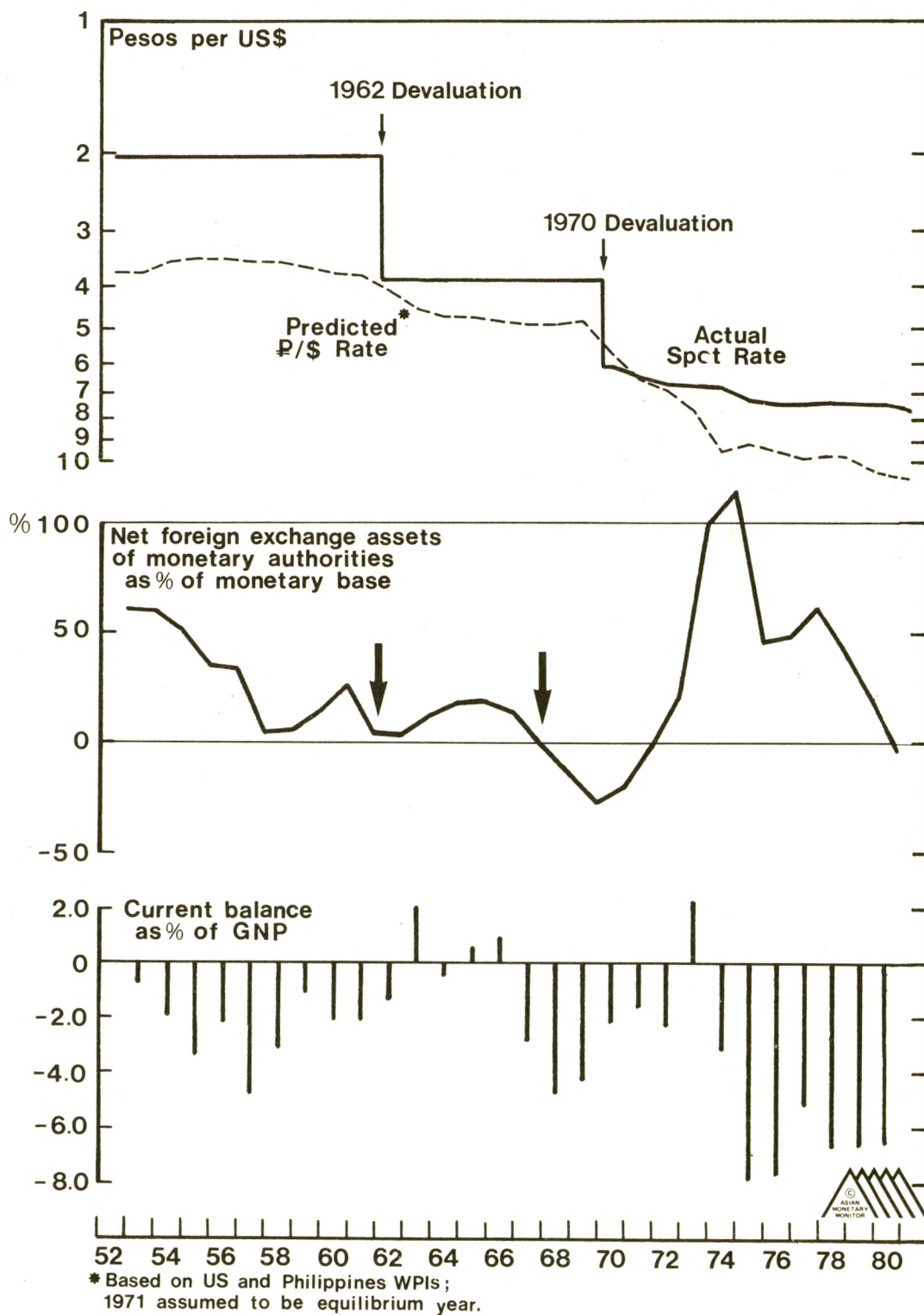


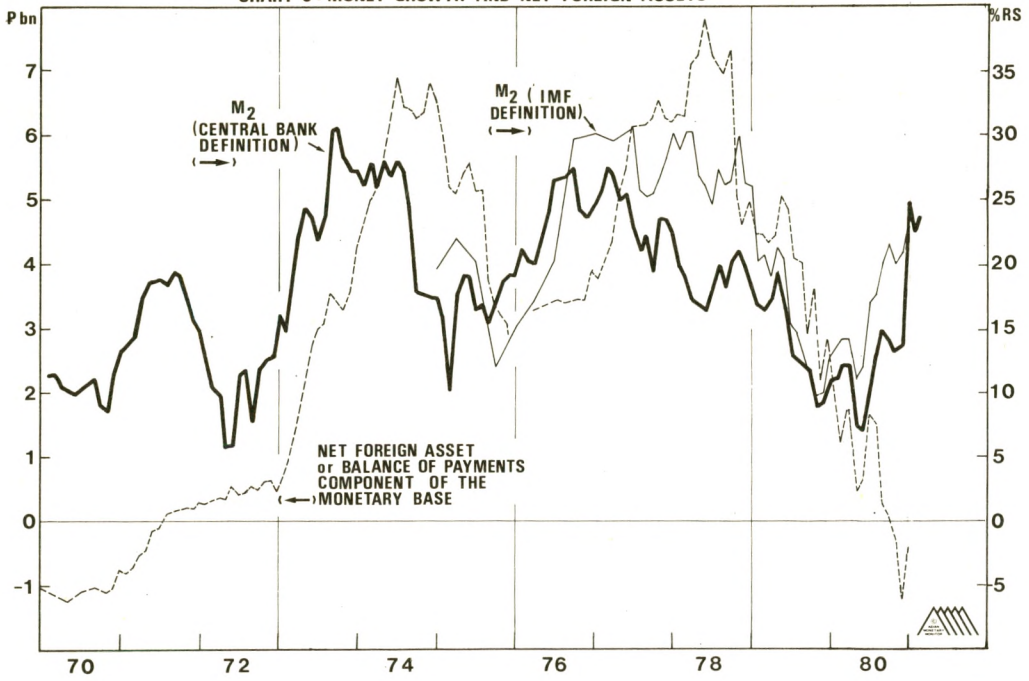
CHART 4 PHILIPPINES

DETERMINANTS OF THE P/US\$ EXCHANGE RATE

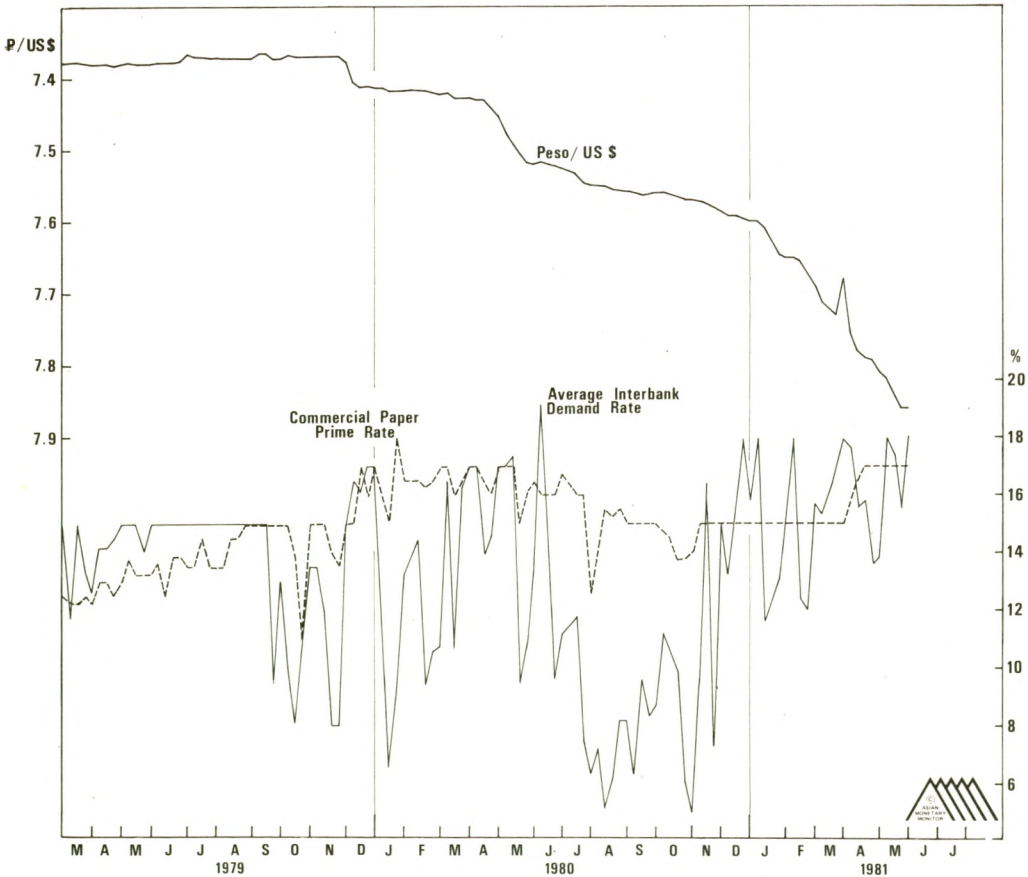


PHILIPPINES

CHART 5: MONEY GROWTH AND NET FOREIGN ASSETS



PHILIPPINES: CHART 6 MONEY MARKET RATES AND THE PESO



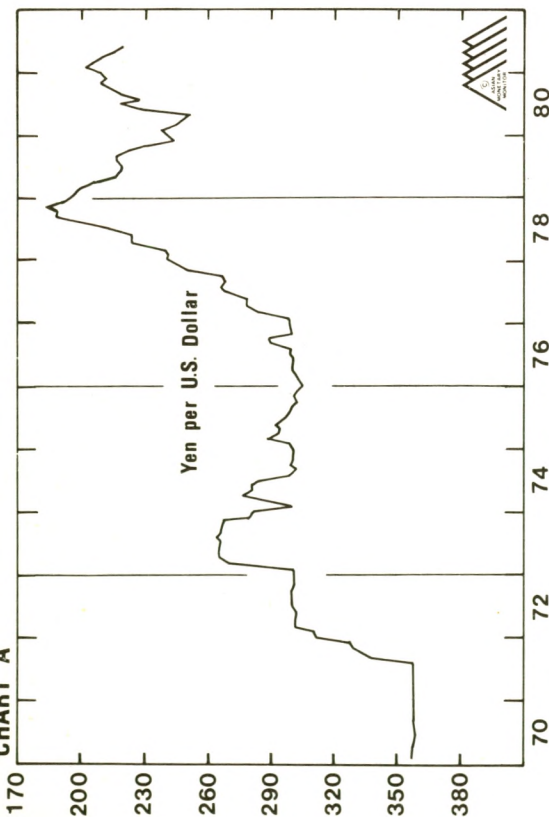
money growth peaking in 1976 or 1977 well ahead of the peak in net foreign assets in 1978. Since the start of 1980 an even wider gap has opened up reflecting the more discretionary policy of the Central Bank. Monetary growth has accelerated, especially - and perhaps ominously - in December 1980 and January 1981 while the net foreign asset position has plunged to the point where the Central Bank's balance sheet actually shows net liabilities.

One element of policy which has enabled this divergence to occur is the decision to allow the Peso to move gradually downwards on the foreign exchange market (Chart 6). The daily guiding rate set by the Central Bank has moved steadily downwards against the US\$ (with the occasional upward spike), but it is doubtful whether the depreciation so far is sufficient to permit the balance of payments to strengthen significantly without continuous dependence on large capital inflows.

There are essentially two polar alternatives which may be adopted by any central bank. Either it may adopt a freely floating exchange rate, in which case the balance of payments will not act as a constraint on monetary policy, or it may peg the rate and allow the balance of payments to dictate the stance of domestic monetary policy. In other words one may have either a floating exchange rate with full discretion, or a pegged rate with no discretion. In 1980 the Philippine authorities seemed to try to compromise, having a guided rate but retaining as much discretion as possible. Under the new Central Bank Governor a choice will have to be made between continuing internal expansion on the one hand and accepting the discipline of the worsening external position on the other. The lesson of history and the condition of the external accounts suggest that the choice will have to be made quite soon.

FORECAST: The Philippine Peso has been under downward pressure owing to a fundamental failure to correct the weakness in the nation's trade and current accounts. The only ways to achieve such a correction are either to undertake a massive restructuring of the economy to meet the new pattern of world prices following the 1979-80 oil price increases, or to permit the external cash drain to translate into a monetary slowdown which in turn would choke off the demand for imports. To date there is little sign that the Philippines is moving deliberately in either of these directions. Some restructuring has occurred: the manufacturing export sector is growing rapidly, and the country has a nascent oil industry, but this is a long and slow path to tread. The quickest results would be obtained through monetary discipline, a course the authorities under the previous CB Governor were apparently reluctant to adopt. Under the new Governor it is to be hoped that a more hard-nosed approach will be adopted. The alternative is a more rapid Peso depreciation, possibly requiring an explicit devaluation.

JAPANESE YEN CHART A



The Japanese yen has depreciated by about 12% against the dollar since the beginning of this year, and has thus proved much weaker against the US dollar than we had anticipated. The principal reason for the US dollar's strength lies in the fact that short term US interest rates rose sooner and more rapidly than we had foreseen, but it is nevertheless crucial to try to ascertain whether the yen's recent performance reflects incipient fundamental cyclical weakness.

Strangely enough, it is probable that the current strength of the US dollar primarily reflects a failure on the part of the US monetary authorities to pursue their intended monetary policy. The Federal Reserve had hoped to gradually reduce the growth of the US monetary aggregates during the course of this year. However as is evident in Chart E, yearly M2 growth in America has remained stubbornly around the 10% level. The Federal Reserve's efforts to reduce monetary growth whilst the demand for money remains buoyant have naturally resulted in rising interest rates. This has occurred during a period of seasonally declining rates in Japan and thus the interest differential in favour of the US dollar has widened as depicted in Chart C. However there have been other bullish influences behind the US dollar's strength. Gathering confidence in the foreign exchange markets that the Federal Reserve's restraint will produce

a sustainable slowdown in US inflation, coupled with an improved trade account performance, have underwritten the US dollar's appreciation.

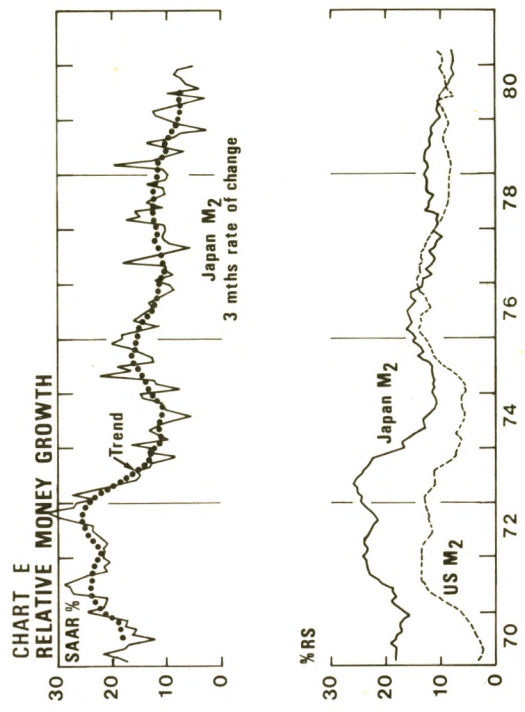
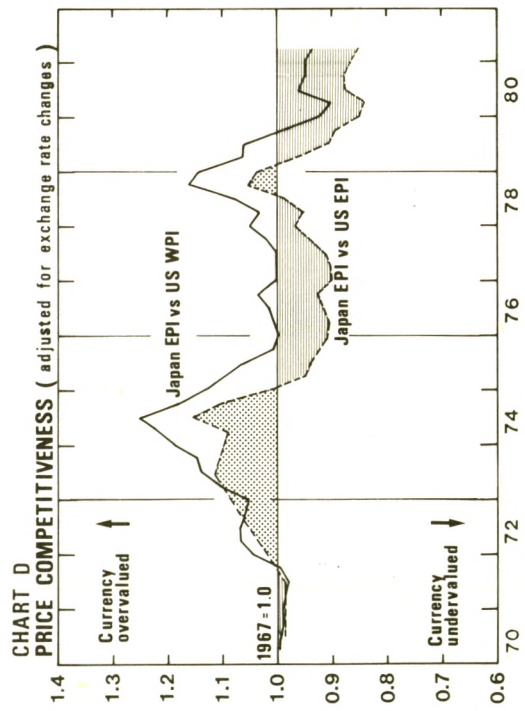
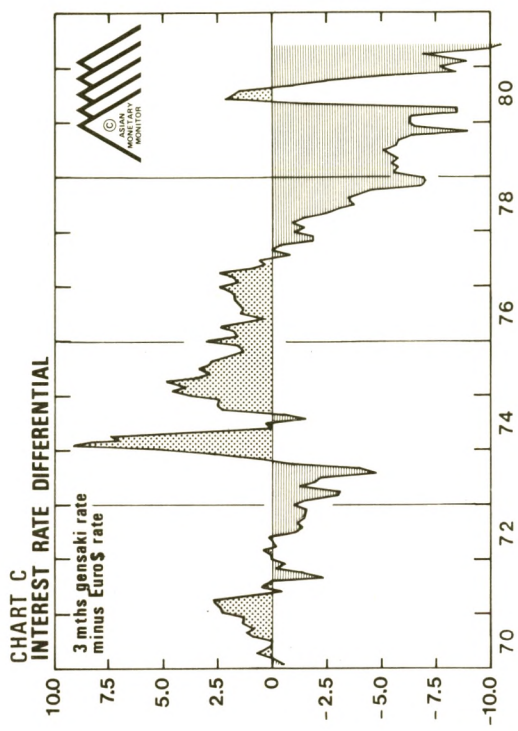
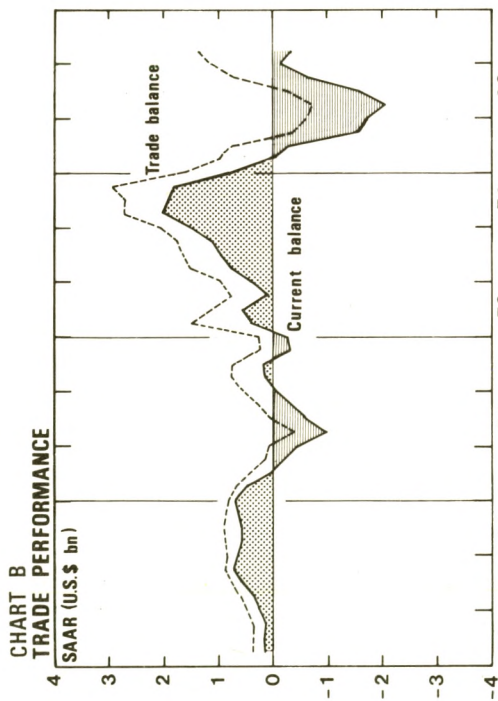
Nevertheless we remain of the opinion that at present levels the yen should prove more than equal to the improved longer term prospects for the US dollar. First, in spite of the likelihood of lower inflation in the US, Chart D suggests either that, in terms of relative inflation levels, the yen is as undervalued relative to the US dollar as at any time during the past decade, or that the foreign exchange markets are already discounting a very dramatic improvement in US inflation relative to Japan's. This would require prolonged monetary restraint by the Fed, and suggests that the US\$ would prove vulnerable to any hint of an easier stance. Second, Japan's trade and current account position remains favourable. It is true that economic activity in Japan is likely to improve in the coming months and that this is usually associated with increased import demand. However the gap between import and export growth remains just slightly less than 20%. This indicates that the external account is likely to continue improving, albeit at a slower rate, and that the yen is still very competitive on non-interest rate fundamentals.

Nevertheless, the shorter term outlook for the ¥/\$ rate remains almost entirely dependent on the course of US interest rates. We doubt that the Federal Reserve will adopt an easier stance whilst monetary growth remains above target. Thus if the US economy remains relatively buoyant it is likely that US interest rates will remain firm, resulting in further short term downward pressure on the yen.

Yen/US\$	ACTUAL			FORECAST	
	1981 Q1	Apr. -May	Q3	Q4	
FORECAST A					
Actual Range	199.15-211.00	212.20-224.30	222-232	228-240	
FORECAST B			215-230	205-220	

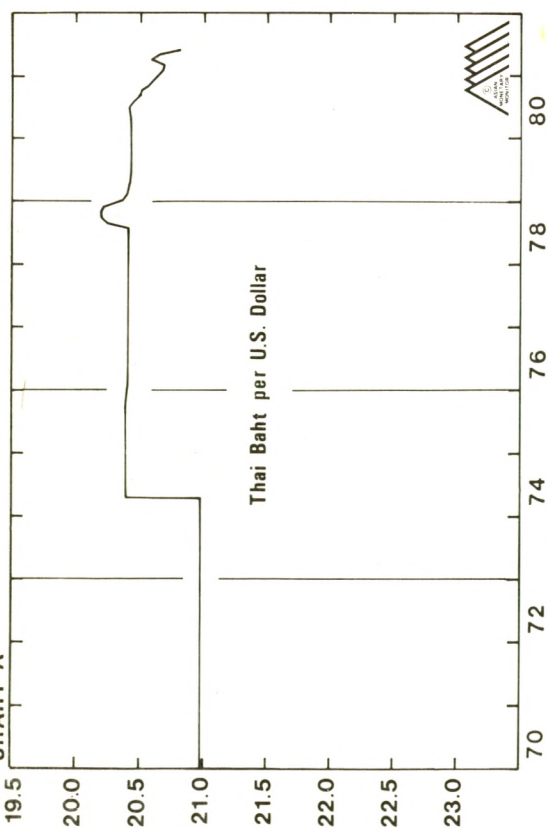
Forecast A assumes that the US economy continues buoyant in spite of Federal Reserve efforts at restraint and that there is therefore no significant downward trend in US interest rates.

Forecast B assumes that the current level of US interest rates will slow US economic activity sufficiently for the Federal Reserve to be able to achieve its monetary targets at lower interest rates.



EPI : EXPORT PRICE INDEX
SAAR: SEASONALLY ADJUSTED AT ANNUAL RATE
RS: RATE OF CHANGE OVER SAME MONTH OF PREVIOUS YEAR

THAI BAHT CHART A



In the last edition of AMM we argued that Thailand's domestic monetary policies were very likely to undermine the baht's existing exchange rate with the US dollar. For all practical purposes the baht has been pegged to the US dollar for the past twenty years, but in recent years it appears to us that there have been growing pressures for a devaluation of the Thai currency. We cautioned (AMM Vol. 5 No. 1) that the IMF has refused to sanction a third tranche of IMF loans unless the Thai authorities depreciated their currency by 10%. Substitute sources of foreign loans have enabled the government to avoid additional borrowings at the IMF and thus a significant depreciation of the baht has been avoided. Nevertheless the Thai authorities have reached a compromise with the IMF and agreed to depreciate the baht by approximately 1% every six months until the end of 1981. Confirmation of this policy emerged on May 12 when the baht was devalued to Baht 21 = US\$1.00.

This small adjustment has done very little to improve the baht's overall price competitiveness, as may be seen in Chart D. More importantly, whatever small gains that may have been made are likely to prove temporary. Tinkering with the exchange rate in this way does absolutely nothing to correct the underlying cause of the present downward pressure on the baht which is the widening inflation

differential between Thailand and the US. Consumer and wholesale price inflation in Thailand is currently running at a yearly rate of around 15%. It is very unlikely that this rate will fall appreciably during the coming year. After having gradually restrained monetary growth in 1978 and 1979, the Bank of Thailand has followed a much easier stance during the past eighteen months and M2 growth has accelerated to over 20% year-on-year. Moreover the Thai authorities show no sign of reversing the policies which have fostered excessive monetary expansion. They have continued to approve large overseas loans in order to "finance" Thailand's burgeoning trade deficit. Economic growth has thus prospered temporarily, but the cyclical downturn in monetary growth typically associated with pegged exchange rate economies has been postponed.

Thus Thai inflation is likely to continue to deteriorate relative to inflation in the US, thereby increasing the prospect of further and larger baht depreciation during the course of the next several months. The Thai baht remains fundamentally weak.

Baht/US\$	ACTUAL		FORECAST	
	1981 Q1	Apr.-May	Q3	Q4
FORECAST A				
Actual Range	20.67-20.70	20.58-20.92	23.5	23.5
FORECAST B			21.0-21.5	21.25-21.75

Forecast A: Based on a simple projection of relative price competitiveness shown in Chart D i.e. the exchange rate required to bring US and local price levels into line.

Forecast B: The most likely range in the absence of some major political or external disruption.

CHART B
TRADE PERFORMANCE

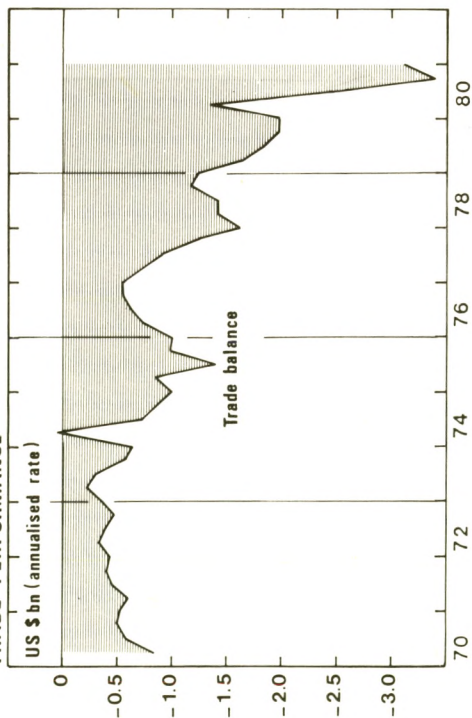


CHART C
INTERNATIONAL RESERVES

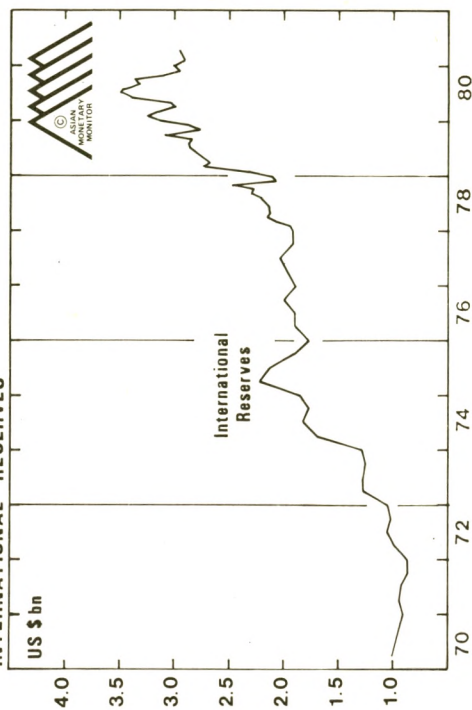


CHART D

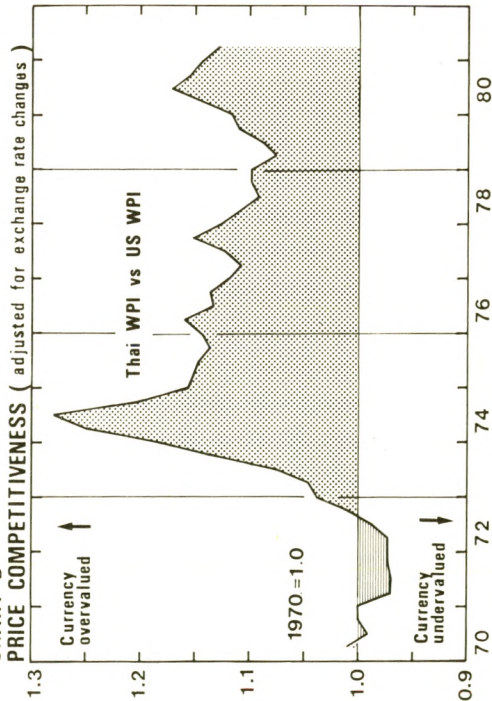
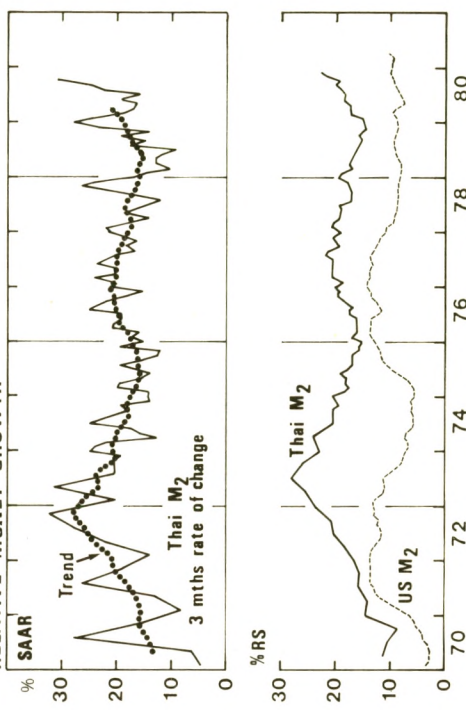
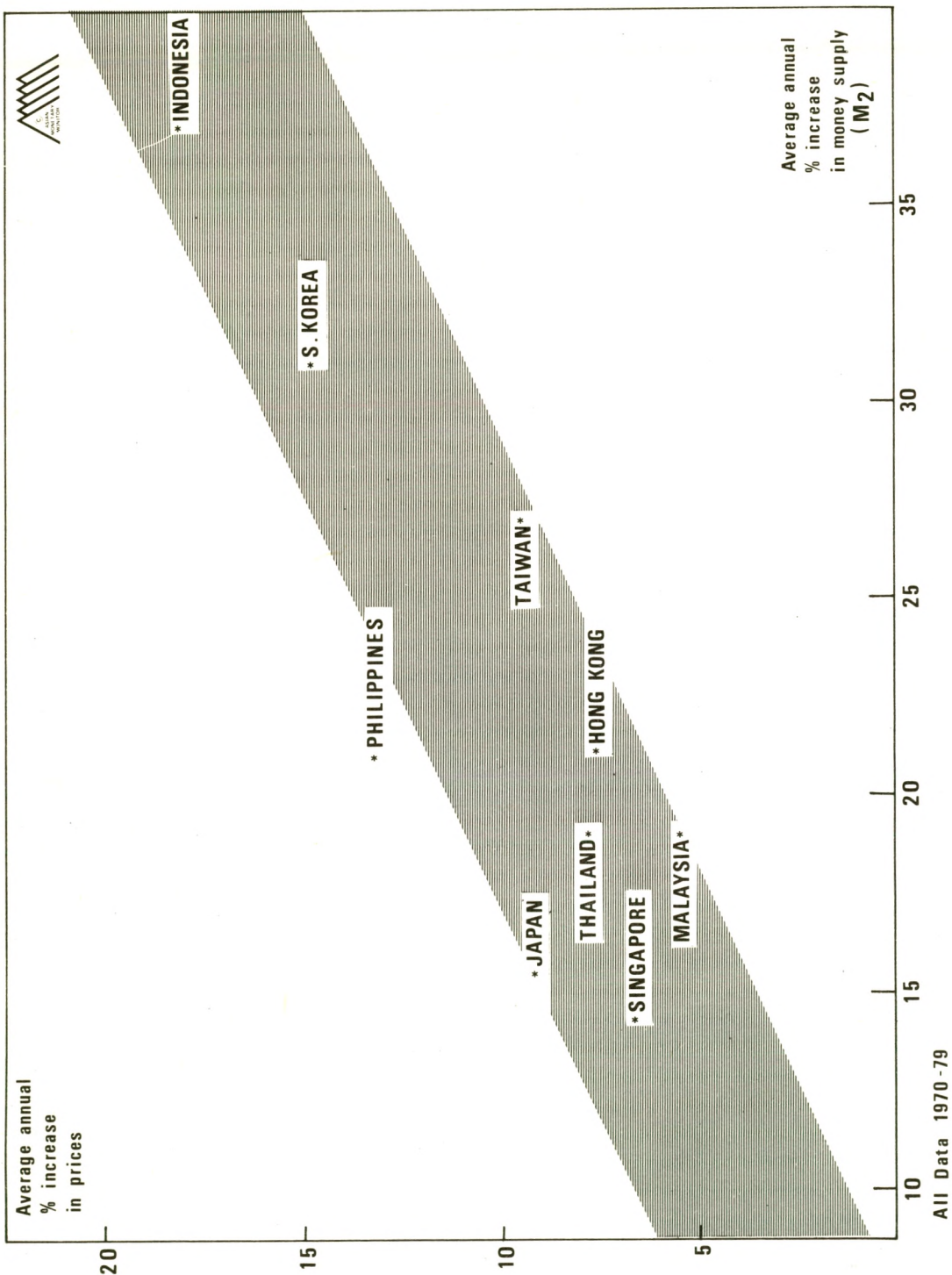


CHART E
RELATIVE MONEY GROWTH



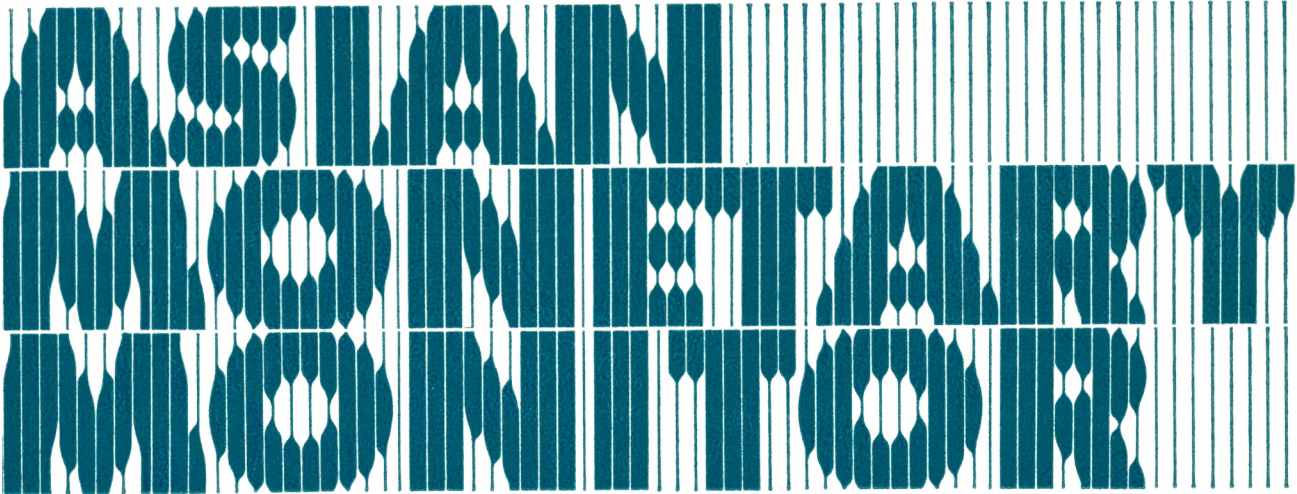
SAAR: SEASONALLY ADJUSTED AT ANNUAL RATE
RS: RATE OF CHANGE OVER SAME MONTH OF PREVIOUS YEAR

RELATION BETWEEN MONEY SUPPLY GROWTH AND INFLATION





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CONTENTS

THE DEBATE OVER U.S. INTEREST

RATES:

Monetary Analysis and Credit
Analysis Have Different
Implications.

HONG KONG:

Currency on the Skids

SOUTH KOREA:

An Incipient Recovery

When Will Foreign Portfolio
Investment in Korea Be
Permitted?

EXCHANGE RATE FORECASTS:

Malaysian Ringgit
Philippine Peso

Pa

1

2

3

4

5

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CONTENTS

	Page
THE DEBATE OVER U.S. INTEREST RATES:	2
Monetary Analysis and Credit Analysis Have Different Implications.	
HONG KONG	
Currency on the Skids	18
SOUTH KOREA	29
An Incipient Recovery When Will Foreign Portfolio Investment in Korea Be Permitted?	34
EXCHANGE RATE FORECASTS:	
Malaysian Ringgit	36
Philippine Peso	38

KEY TO SYMBOLS USED IN THE CHARTS

% RP - Percentage Rate of change over Preceding period.

% RS - Percentage Rate of change over Same period of
preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

THE DEBATE OVER U.S. INTEREST RATES: MONETARY ANALYSIS AND CREDIT ANALYSIS HAVE DIFFERENT IMPLICATIONS

The very high level of short term interest rates in the US is having increasingly serious repercussions for the currencies and stockmarkets of most countries in the Asian Pacific Rim. Until recently it was widely believed that US interest rates would peak relatively quickly. Expectation of a decline in the US dollar as rates fell tempered strength in the US currency which had already appreciated ten percent during the first half of this year. The same expectations also stemmed potential weakness in regional stockmarkets. If high US interest rates were to prove a temporary phenomenon, investors could concentrate on a generally improved domestic outlook, since the risk of defensive increases in local interest rates would quickly recede.

In the event, of course, expectations that US interest rates would soon decline have been disappointed. Apart from a brief reduction at the beginning of June, US banks' prime rates have remained in excess of 20% since the middle of May. In the light of the critical importance of the trend in American interest rates for regional currencies and stockmarkets, we have sought to outline some of the main arguments in the current debate.

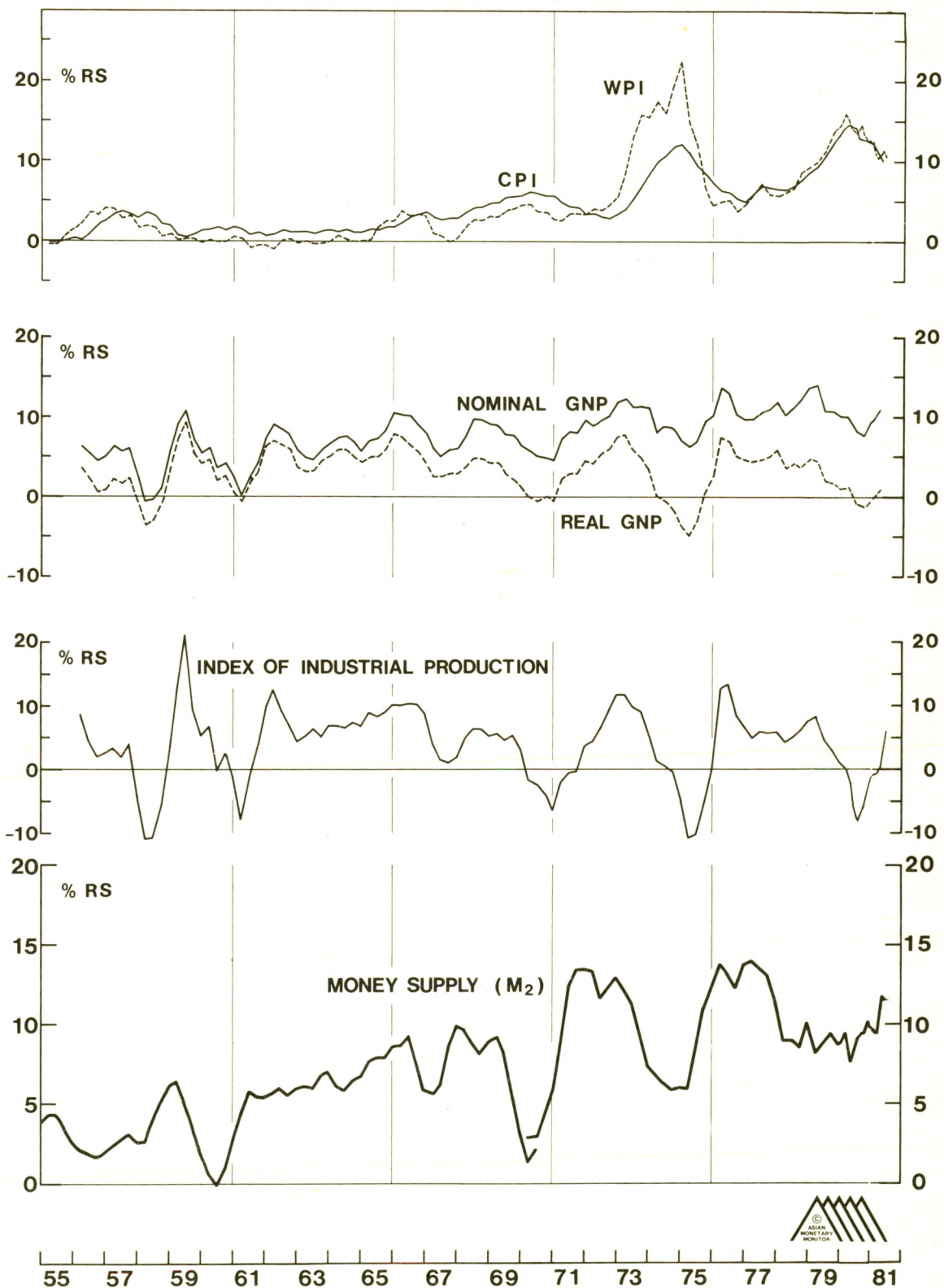
Naturally these arguments centre on where the US economy lies in its present business cycle. However, it is astonishing how so many well respected and experienced commentators can fail to reach agreement on the interpretation of even the broadest features of the present business cycle. There is no consensus, for example, as to whether the US economy is closer to a cyclical peak than a cyclical trough.

Cyclical Variables

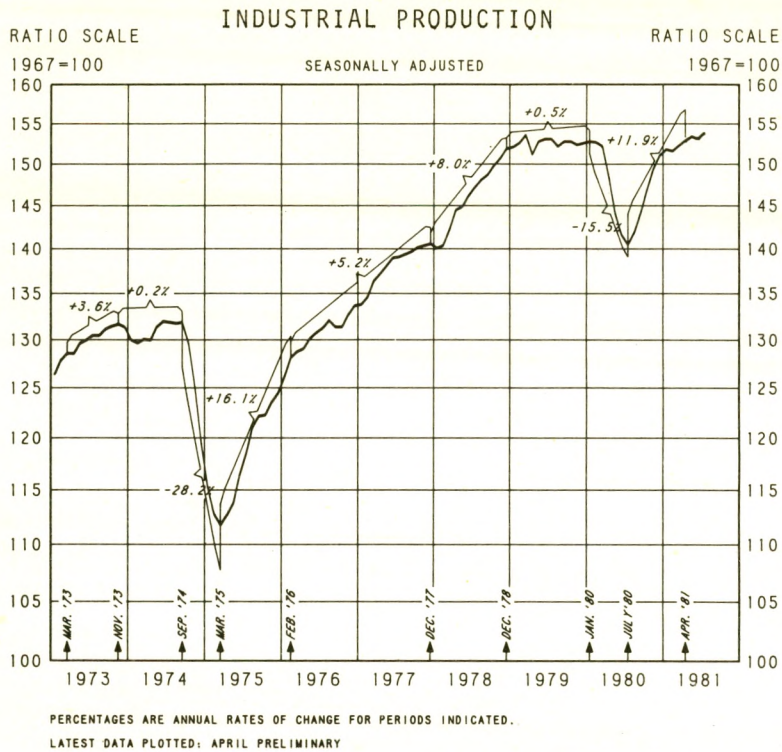
The question of the direction of interest rates in the US illustrates the current breadth in the spectrum of views on the economy. Those who are bearish of US interest rates are so primarily because they view the economy as being closer to a cyclical trough than a cyclical peak. One school of analysts including Henry Kaufman, for example, feels that the economy is ending the first year of an irregular two or three year upswing. If this view is right then the Federal Reserve will, in all probability, encounter serious difficulty in achieving its monetary targets and it is therefore likely that interest rates will reach new all time highs sometime during the course of the year in spite of declines in inflation. By contrast, another school of thought including Erich Heinemann at Morgan Stanley is bullish of US interest rates basically because he takes the stance that there is little upward momentum left in the economy and hence that interest rates will drift down following the reduction in inflation he anticipates throughout this year.

U. S. A.

CHART 1 : MONEY, OUTPUT, AND PRICES

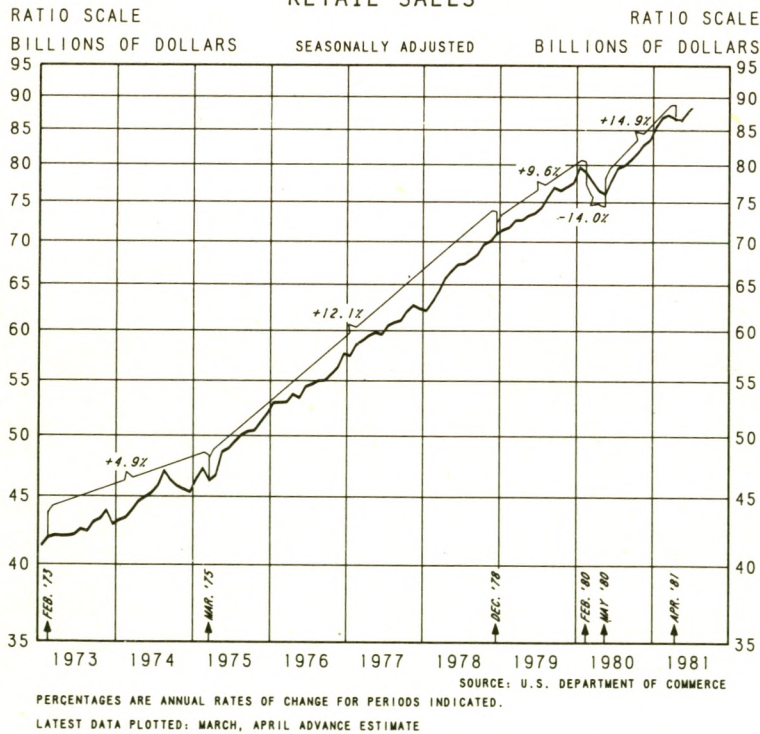


USA: CHART 2

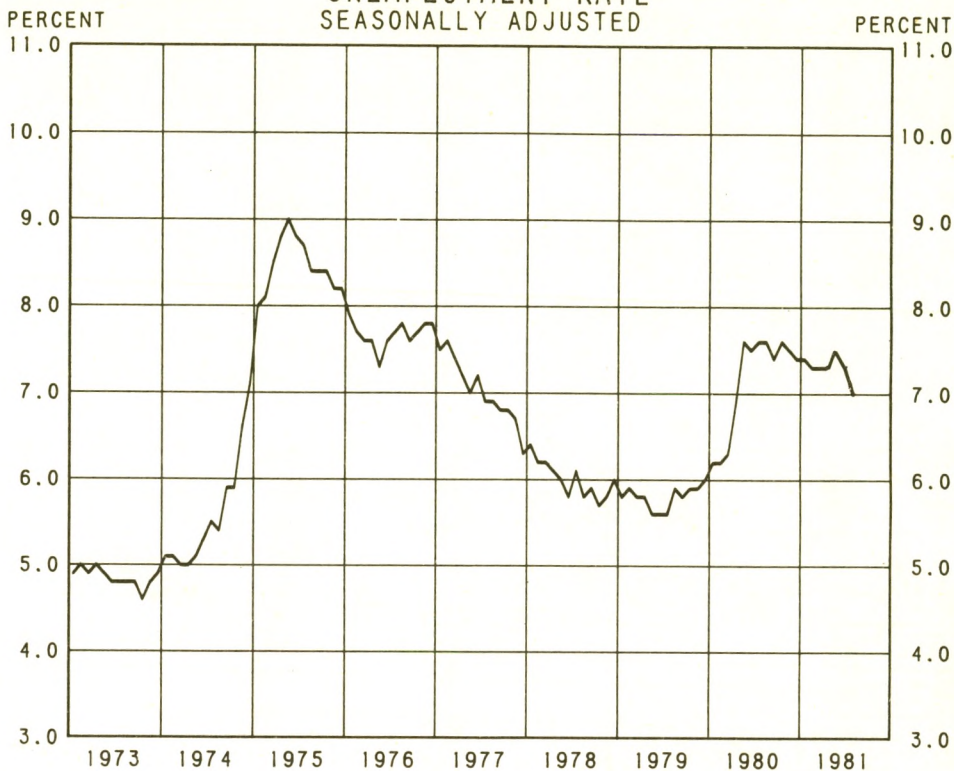


USA: CHART 3

RETAIL SALES



USA: CHART 4 UNEMPLOYMENT RATE SEASONALLY ADJUSTED

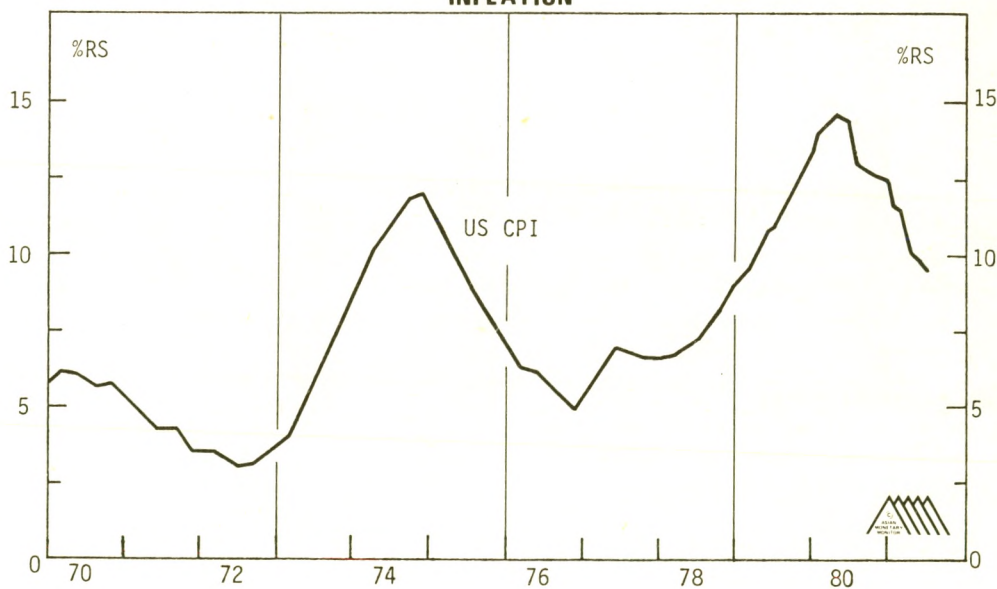


PERCENT OF CIVILIAN LABOR FORCE
LATEST DATA PLOTTED: APRIL

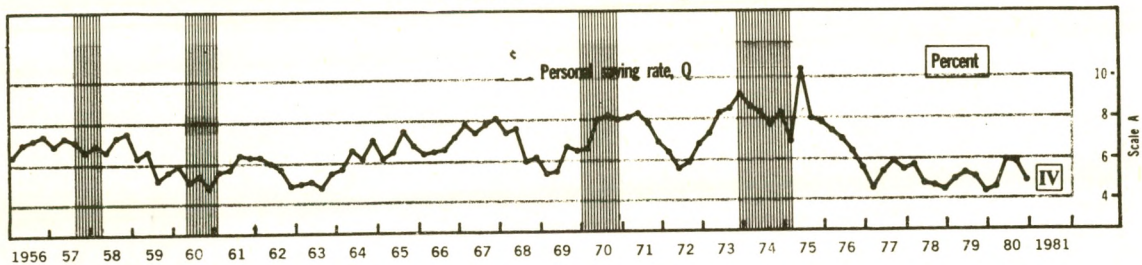
SOURCE: U.S. DEPARTMENT OF LABOR

PREPARED BY FEDERAL RESERVE BANK OF ST. LOUIS

USA : CHART 5 INFLATION

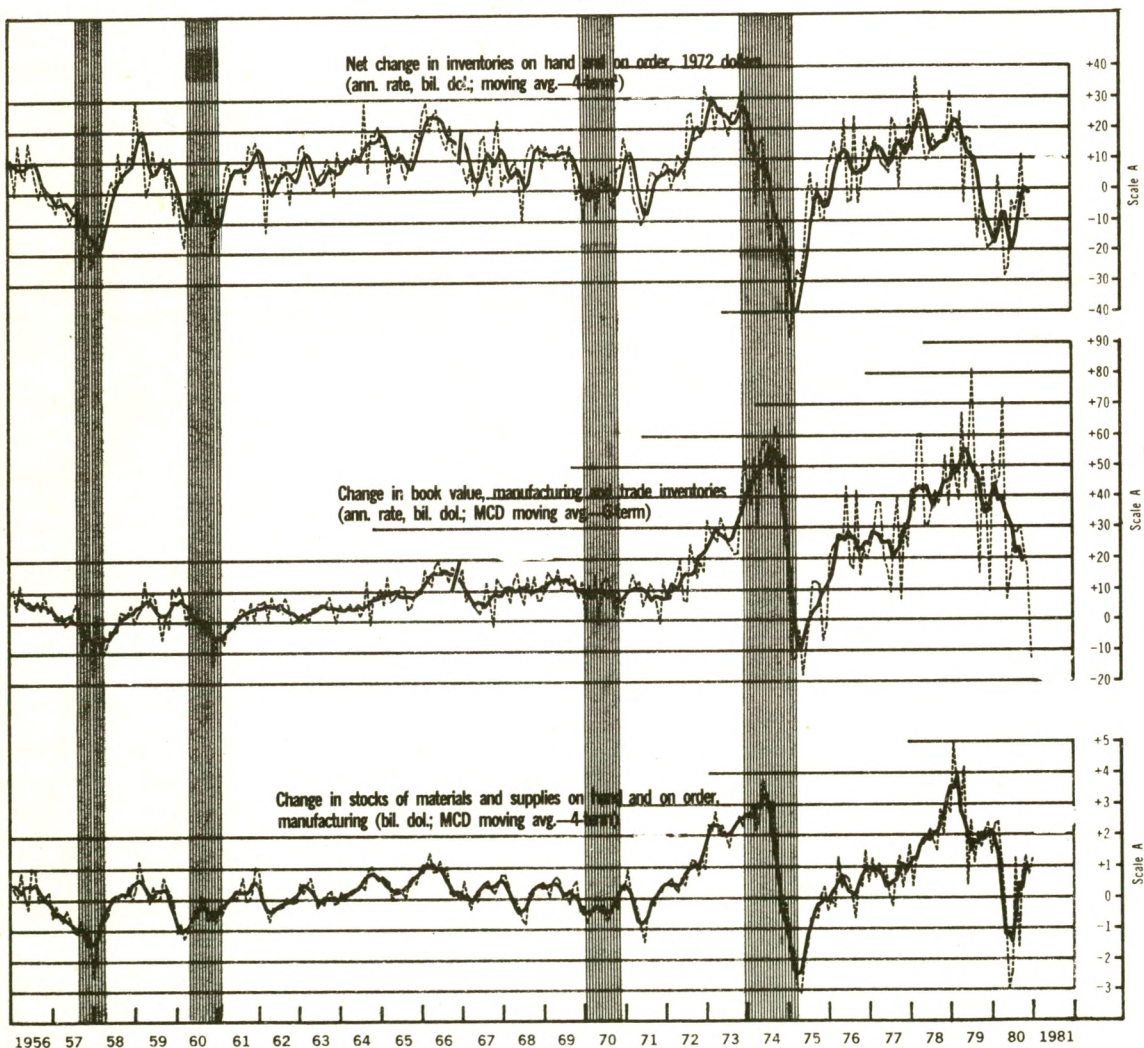


USA: Chart 6 Personal Savings



Source: Business Conditions Digest, U.S. Dept. of Commerce

USA: Chart 7 Inventories



¹ This series is a weighted 4-term moving average (with weights 1,2,2,1) placed on the terminal month of the span.

Source: Business Conditions Digest, U.S. Department of Commerce

This diversity of views on the likely trend in US rates follows, of course, as a consequence of the ambiguous implications of recent economic indicators. The trends in industrial production, retail sales, unemployment and inflation (see Charts 2-5) are consistent with the view that the economy is in an upswing which has temporarily moderated during recent months. The patterns of durable goods production, capital expenditure and unit wage costs reveal similar cyclical trends. This is arguably the irregular recovery which Kaufman has in mind.

Nevertheless it is clearly a recovery with some very unusual characteristics. The most obvious of these is that in previous cyclical upswings, the first year of a business expansion was one in which interest rates not only fell but also where the yield curve was positively sloped. However for almost the whole of the period beginning in June 1980 the yield curve has been inverted. This has important repercussions in that it discourages investors from committing funds to the longer end of the market. This in turn restricts the funding of corporate liabilities from short to long term. This has proved an important reason behind a further unusual facet of the recent recovery: there has been little if any improvement in corporate balance sheets. Typically corporations use periods of recession and the initial stages of recovery to restructure their balance sheets by substituting long for short term liabilities. This only occurred, by and large, for a short period in May, June and July of last year. Corporations as a whole have done little to restore their weakened financial positions. The counterpart to this has been continued strong loan demand at the banks who have not, as in comparable periods during the past, appreciably increased their holdings of fixed interest securities during the past year.

Similarly individuals' balance sheets have not exhibited the type of changes usually associated with cyclical recoveries. There was only a small rise in the savings ratio during the first half of 1980, and this has since been reduced close to record low levels (see Chart 6).

High interest rates have also altered the shape of recovery over the last year. The interest sensitive sectors of the economy - notably the automobile and construction industry, but also the utilities - which have typically led recoveries in previous cycles, have remained depressed. The recovery has been selective, both in terms of sectoral and regional performance.

Stratospheric interest rates over the last year have also added an important element of support to the recovery in business activity. This apparently remarkable assertion stems from the fact that high short term rates and financing costs have encouraged many businesses to maintain low inventory levels. As may be seen in Chart 7, the recovery in inventory levels has been more muted than in the past - especially in comparison with the 1975 recovery.

Those commentators who are bullish, in the medium and long term, of US interest rates argue that these differences in the current, alleged, recovery are so significant that they severely undermine the credibility of rate projections based on simple cyclical comparisons. Specifically they argue, in effect, that the "unusual characteristics" of the "recovery" noted by Kaufman and others are the consequence of a restrictive monetary policy on the part of the US Federal Reserve. This restrictive stance will lead to low or negative real monetary growth being maintained and hence, it is argued, a flat economy and falling interest rates are likely for the remainder of the year.

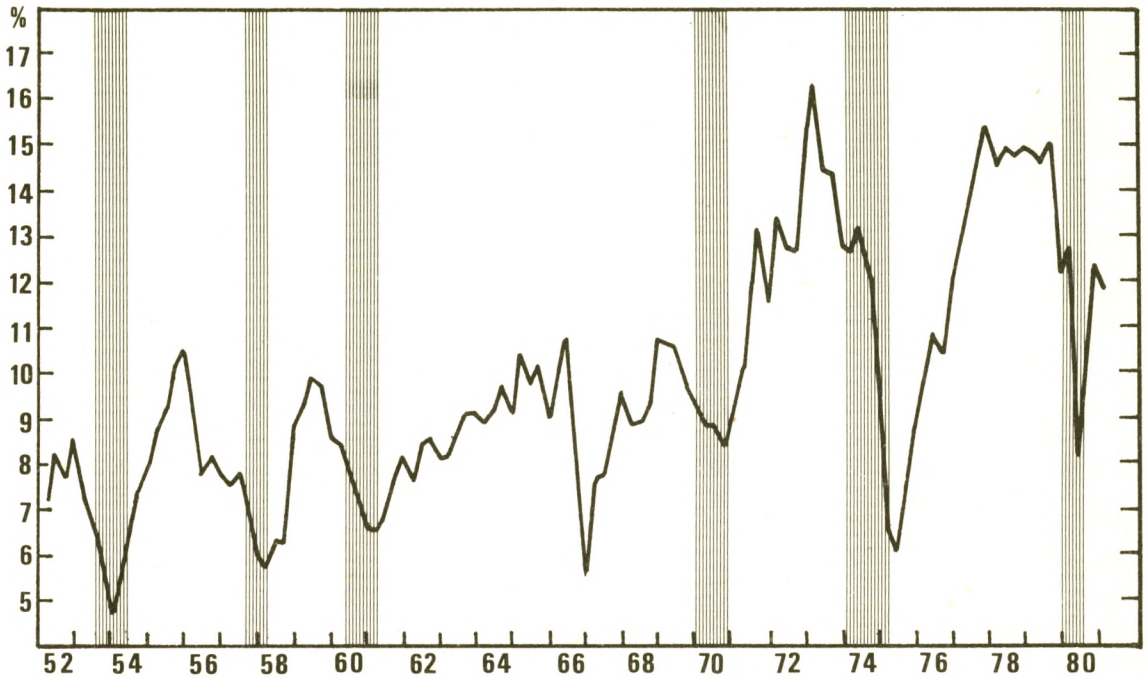
Nevertheless, the "restrictive monetary policy" argument is double edged. Kaufman argues that there are a number of other variables which augur for continued upward momentum in the economy. Thus "financial conditions may become even more precarious if monetary policy continues to be saddled with most of the burden of slowing inflation".*

The underlying reason for the disparity in views on the US economy's cyclical position lies in the divergent trends evident in real money and credit growth. As may be seen from Charts 8 and 9 credit growth, as measured by domestic private non-financial borrowing, and real monetary growth have in the past proved to be about equally competent lead indicators for the strength of the economy. The ratio of borrowing by the domestic private non-financial sector to nominal GNP tends to fall sharply in advance of, and then during, economic slowdowns. The sharpest declines typically occur in the wake of credit crunches either as a result of financial collapse (e.g.: Franklin National in 1974, or Penn Central in 1970) or as a result of short term market rates rising above deposit rate ceilings (as in 1959, 1966 and again in 1974). In all cases credit crunches are characterised by a swift contraction in the supply of credit - borrowers are unable to fulfil their demands at any price. This is probably what occurred in March 1980. Consumers, in particular, were arbitrarily excluded from large segments of the credit markets.

In past business cycles the trend in domestic private non-financial borrowing and real monetary growth has tended to be synchronised. (Nevertheless, note their divergence in 1979 - the credit indicator successfully predicted continued growth in the economy, a result which confounded many monetarists.) However during the last nine months there has been a significant disparity between the two indicators. Private non-financial borrowing has risen quickly in a way characteristic of an upswing in the business cycle, whilst real monetary growth remains in negative territory thereby prompting projections of a flat economy with little upward momentum or pressure on rates. Herein lies the basis for the wide spectrum of views on the underlying direction of US rates.

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* Henry Kaufman: The Potential for Conflict in National Policies and in Financial Markets. Salomon Brothers Bond Market Research, April 1981.

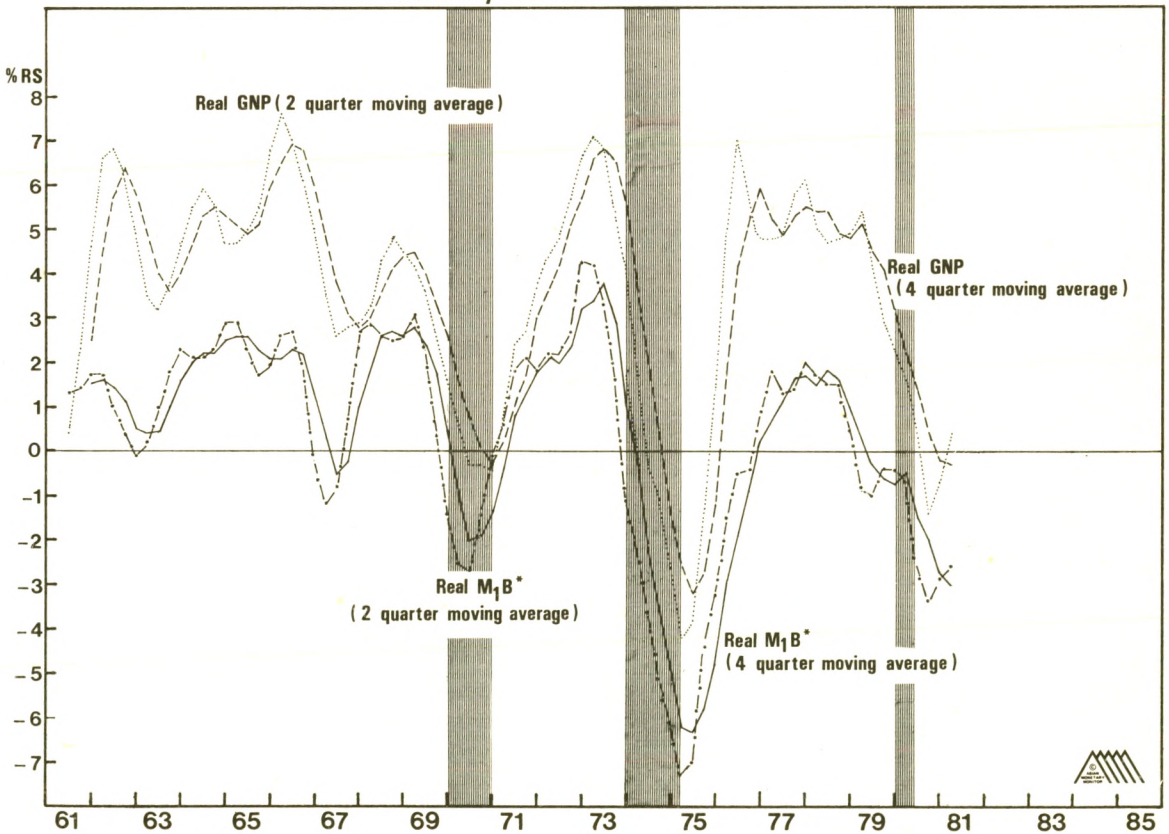
Borrowing By Domestic Private Nonfinancial Sectors/GNP



Source: Goldman, Sachs

USA: Chart 9

Real Monetary Growth and Real GNP Growth



*Deflated by Implicit Price Level

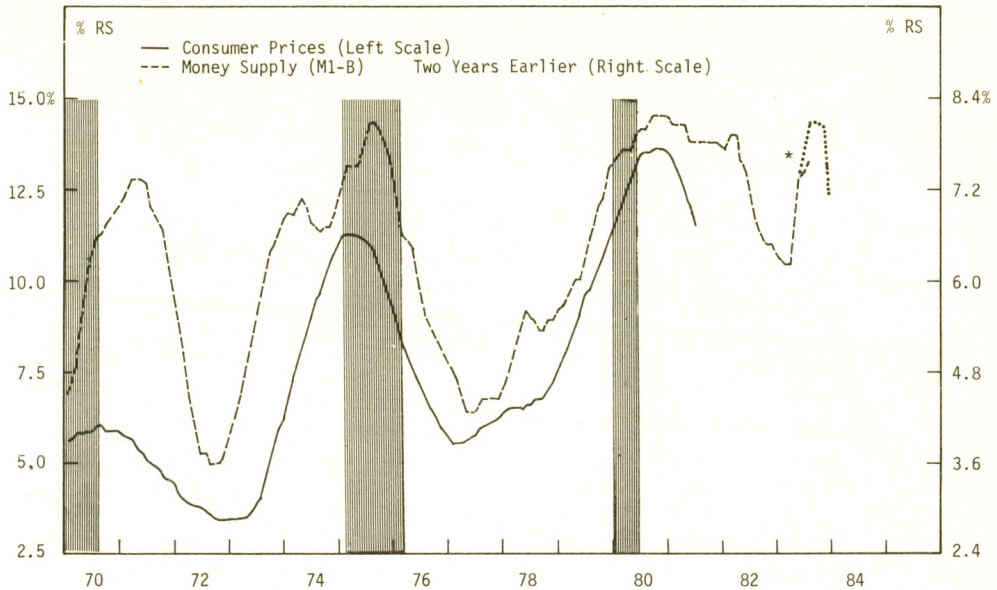
Although these two indicators differ in their short to medium term implications for US rates they are agreed on two important points. Neither indicator projects a fully fledged recession this year, and both tend to suggest a trough in inflation during the summer of 1982 (see Charts 10 and 11). The projection that the US economy will not enter a recession this year, in spite of the Federal Reserve's supposedly restrictive stance, stems from three broad factors.

First, monetary growth remains stubbornly high (on a year-to-year view) in spite of the fan-fare surrounding the Fed's "restrictive" stance. M2 growth is currently around 9% year-on-year and unadjusted M1B's year-to-year increase is in the region of 8%. Although these growth rates can be expected to decline during the rest of the year, and although this has typically increased the probability of a recession, a second important factor mitigates the likelihood of a downturn in economic activity. This second factor is the sharp reduction in US inflation over the last fifteen months. The decline in inflation makes it more difficult for the Federal Reserve to engineer the type of contraction in real monetary growth which is a typical feature of the period preceding US recessions. It is hard to identify a recession, either in the US or anywhere else, which has not been associated with a cyclical peak in consumer price inflation.

A third factor that suggests continued upward momentum in the US economy is that there is no sign, as yet, of a decline in non-financial private sector borrowing which would typically precede a recession. The minimum lag between a downturn in the borrowing ratio and recession has been two quarters (see Chart 8). It might be argued that the fairly tight correlation between the private borrowing ratio and real GNP fails to show the direction of causality between the two variables. In other words the ready availability of credit promotes real economic growth, but it could be argued that the causation goes the other way and that borrowing is high because economic growth is high. However, the borrowing ratio indicated in Chart 8 reflects the rate of private borrowing relative to GNP. There is little reason to suppose that as real growth picks up so private borrowing relative to GNP will also rise. Causation appears to run from the relative availability of credit and rising borrowing to real economic activity.

A much more controversial problem arises if we try to assess the impact of interest rate changes on credit availability and private non-financial sector borrowing. Chart 12 indicates the correlation between the private borrowing ratio and the Fed Funds rate over the past twenty years. The relationship is clearly impressive, but unfortunately there is no real clue to the direction of causality. Once again the bulls and bears of US interest rates are neatly divided on this point. John Rutledge of the Claremont Economics Institute and others argue that high real interest rates and a slack economy will reduce, eventually, the amount of private borrowing. In other words they argue that credit growth will be restricted on the demand side. Kaufman and others like Wojnilower of First

USA : Chart 10 **The Linkage Between Money And Inflation**



Data are 12-month moving averages.

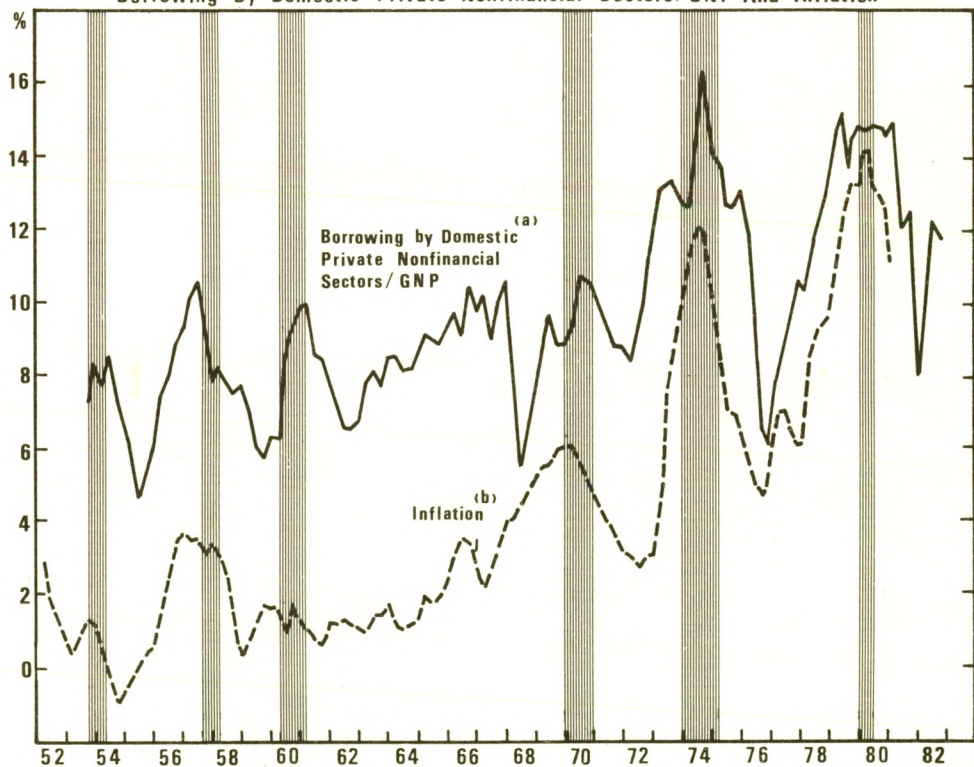
Shaded areas represent periods of recession as designated by the National Bureau of Economic Research.

Sources: Ecomalyst Data Base; Morgan Stanley Research

* Trend in monetary growth assuming M1B increases at a 3½% annualised rate in the 2nd half.

USA : Chart 11

Borrowing By Domestic Private Nonfinancial Sectors/GNP And Inflation



(a) 6-Quarter Lead

(b) 3-Quarter Centered Moving Average of the Consumer Price Index

Source: Goldman, Sachs

Boston, in contrast, claim that the variables which enabled high interest rates to curtail credit growth in previous periods are missing from the current business cycle. In previous business cycles widespread regulated ceilings on deposit rates led to large scale disintermediation as market rates rose above these ceilings. Some borrowers, it is argued, were unable to obtain credit at any price - leading to reduced confidence, often a financial collapse, and then a credit crunch. In other words credit growth was restrained on the supply side. Regulated deposit rate ceilings are now, by and large, a thing of the past. The possibility of large scale disintermediation has thus declined, and with it the possibility of a sustainable reduction in credit.

The problem with the latter approach is that it implicitly assumes that credit demands are interest rate inelastic, and hence that interest rates can only fall swiftly and sustainably in the wake of a credit crunch of one form or another. The implication that credit demands do not respond to changes in interest rates seems hard to swallow, but it should be pointed out that in the past sharp declines in interest rates have indeed generally occurred in the period after credit crunches (i.e. after contractions in the supply of credit).

These projections that the US will not enter a fully fledged recession this year, coupled with the reasoning behind such projections, imply that there is no very strong cause to believe that the underlying trend in short interest rates will in fact be downwards this year: on this view any reduction in rates is likely to be met with a resurgence of repressed credit demands. The Federal Reserve is likely to be obliged to maintain a strict stance irrespective of the decline in inflation.

Influence of Special Factors

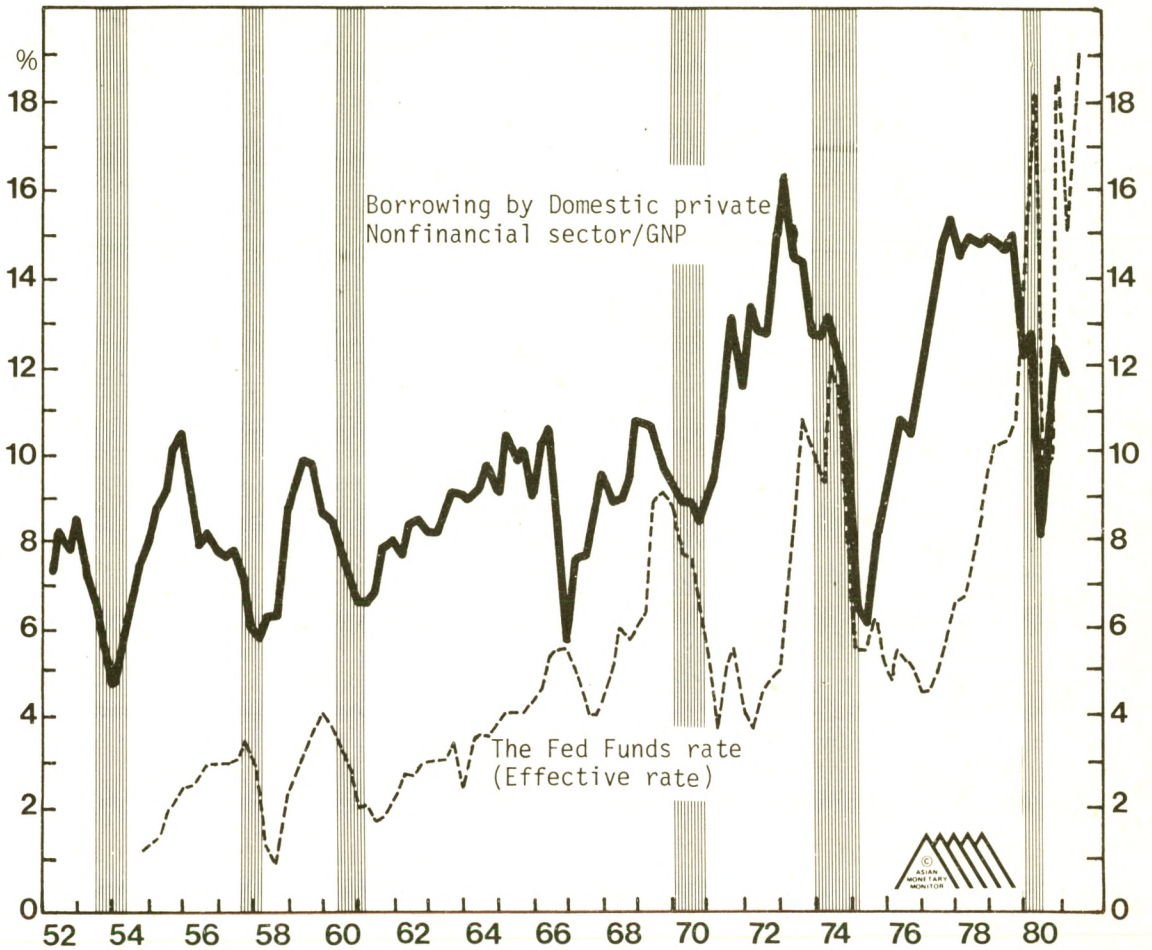
Special, or non-cyclical factors, on the whole seem to favour continued upward momentum in the economy this year. The most important of these are:

- a) The likelihood of tax cuts in both the consumer and corporate sectors later this year.
- b) The published Consumer Price Index is likely to overstate the decline in inflation thereby encouraging business and consumer confidence. The basis for the exaggerated fall in inflation lies in
 - i) the reduction in the relative price of oil,
 - ii) the reduction in the relative price of new homes, and
 - iii) the appreciation of the dollar.

Energy and new home prices account for 7% and 20% respectively of the overall constituents of the US Consumer Price Index. The decline in the relative price of these goods will tend to overstate the fall in consumer price inflation relative to, say, the personal consumption

USA: Chart 12

Borrowing By Domestic Private Nonfinancial Sector / GNP And The Federal Funds Rate



Source: Goldman, Sachs

Private domestic non-financial sector borrowing amounted to US\$281.5 billion (seasonally adjusted, annualised) during the second half of 1980. Its main components were:

New corporate equity issues		US\$ 16.8 billion
State and local obligations		US\$ 26.4 billion
Corporate bonds		US\$ 21.9 billion
Mortgages		US\$133.8 billion
Consumer credit		US\$ 12.4 billion
Bank loans		US\$ 66.1 billion

deflator. Goldman Sachs estimate that the three factors mentioned above could reduce measured consumer price inflation by up to one and a half percentage points during 1981.

- c) Wage contracts. The crucial wage bargaining period begins this autumn. Contracts are negotiated for a longer period than is typical in other countries - usually for three years. In the comparable 1978 wage round many unions underestimated the future rate of inflation. Some "catch up" is likely.

The Influence of the Federal Reserve

We have suggested that the underlying trend is for interest rates to remain high for the remainder of this year. However interest rate volatility around this trend will continue. This primarily reflects the Federal Reserve's willingness to supply reserves relative to the bank's reserve needs. Banks' total reserves are a function of their liabilities. Total reserves are made up of reserves borrowed from the discount window and reserves acquired in the interbank market. The price of "interbank" reserves is the Federal Funds rate. The Federal Reserve can influence the quantity of reserves available in the interbank market through its open market operations. By restricting the growth of interbank, or non-borrowed reserves, relative to the bank's total reserve needs the Federal Reserve can raise the Federal Funds rate. Recent changes in reserve availability suggest that the Federal Funds rate could ease from its current levels.

Nevertheless any easier stance on the part of the Federal Reserve is likely to prove temporary. Any reduction in short term rates will probably be met by a rekindling of credit demands and renewed upward pressure on monetary growth. Basically, it appears that we have not yet reached the point where once the Federal Reserve hits its monetary targets one can sit back and wait for significantly and sustainably lower interest rates. The potential for renewed credit demands and for further resilience in the economy remains strong.

There are basically two factors which would alter this view. First, a combination of monetary policy caution, prolonged high interest rates, and deteriorating corporate balance sheets could lead to growing pessimism on the part of lenders that some corporations are able to repay their short term liabilities. This would lead to a contraction of credit availability, which typically foreshadows a credit crunch. Second, rising yields on financial assets and declining household net worth, could encourage a significant rise in the savings ratio, a temporary fall off in economic activity and falling interest rates as a consequence of the increased demand for financial assets. There is clearly an incentive for this to occur (and this is obviously what the Reagan administration hopes for) but whether this would happen this year is open to doubt.

Secular Variables

The idea that the US has embarked on a course of sustainable disinflation is clearly gathering support following the sharp decline in CPI growth during the last fifteen months and the Federal Reserve's apparent resolve to curtail increases in the monetary aggregates.

Nevertheless it is clear that the Federal Reserve will find it difficult to achieve its target of 6% inflation in 1983. Chart 10 illustrates the monetarist contention that declines in inflation are the result of the lagged impact of falling monetary growth rather than semi random declines in the price in particular goods markets. On this basis we should expect the year-on-year rate of consumer price inflation to trough out at around 8% during the summer of 1982. It is likely that there would then be upward pressure on inflation into 1983.

It is also worth pointing out the fact that the trend in inflation has risen more rapidly than the trend in monetary growth during the last decade. This presumably reflects revisions to corporate and consumer inflationary expectations. Unless these expectations have been revised downwards, this implies that the recent upswing in year-on-year M1B growth carries the potential for greater upward pressure on inflation.

Few people would disagree that monetary restraint is not an important element of the "disinflation" story. However both Kaufman and Wojnilower argue that, in fact, the banking and other credit systems in the US have evolved in such a way as to make meaningful restraint more difficult. Part of a recent speech by Kaufman is worth quoting at length.*

"Let me also call your attention to two other aspects of major importance concerning monetary policy that will continue to come into play in the period ahead. They involve the perception of risk and the role of financial institutions in thwarting the intentions of the new monetarism to stabilise the economy.

The abandonment of interest rate management a year and a half ago carried with it the underlying argument that greater interest rate volatility would heighten the perception of risk in financial decision-making that was previously lacking. Despite the experience of sharp swings in interest rates and the persistence of an inverted yield curve, credit seems to be readily available at some price. Consequently, a perceived interest rate risk is still lacking under monetarism in our new evolving credit system. The interest rate risk is being taken out of both investing and lending decisions through the creation of new floating rate instruments and the sharp increase in short-term financing. As a result, adaptive institutions push hard to create more debt; the supply of credit is controlled by interest rate spreads rather than by interest rate levels. This, in turn, fosters

* Henry Kaufman: "The Potential for Conflict in National Policies and in Financial Markets". Salomon Brothers Bond Market Research, April 1981.

the perception that there is little risk of credit denial under any set of monetary policy rules. Indeed, this perception may be reinforced by monetarism. The mechanics of monetarism imply that interest rates will be allowed to act as a self-correcting force in restoring the rise of money growth to its targeted path.

Thus, it appears, the inherent promise of monetarism is made, that once a rapid rise in money growth is halted, interest rates will be allowed to sink rapidly. This creates the ongoing expectation that the market will not be disciplined by credit denial or lastingly high interest rates. Risks will be perceived as high only when interest rates rise to unexpected heights in a brief period, or when non-monetarist tactics are employed to limit the ability of financial institutions to expand liabilities.

In other words, I would expect financial institutions to continue to push hard to create new debt as interest rates rise, and that we in the securities industry will use all our ingenuity to develop many new credit instruments to drive the credit creation mechanism forward. As a result, the gap between classically defined money and debt and nominal GNP will widen until an excruciating high interest rate level crunches the operating decisions of some in the real world."

In other words, credit growth and monetary growth are likely to continue to diverge, and the Federal Reserve's apparent lack of an appropriate definition of money detracts somewhat from those arguing for secular disinflation.

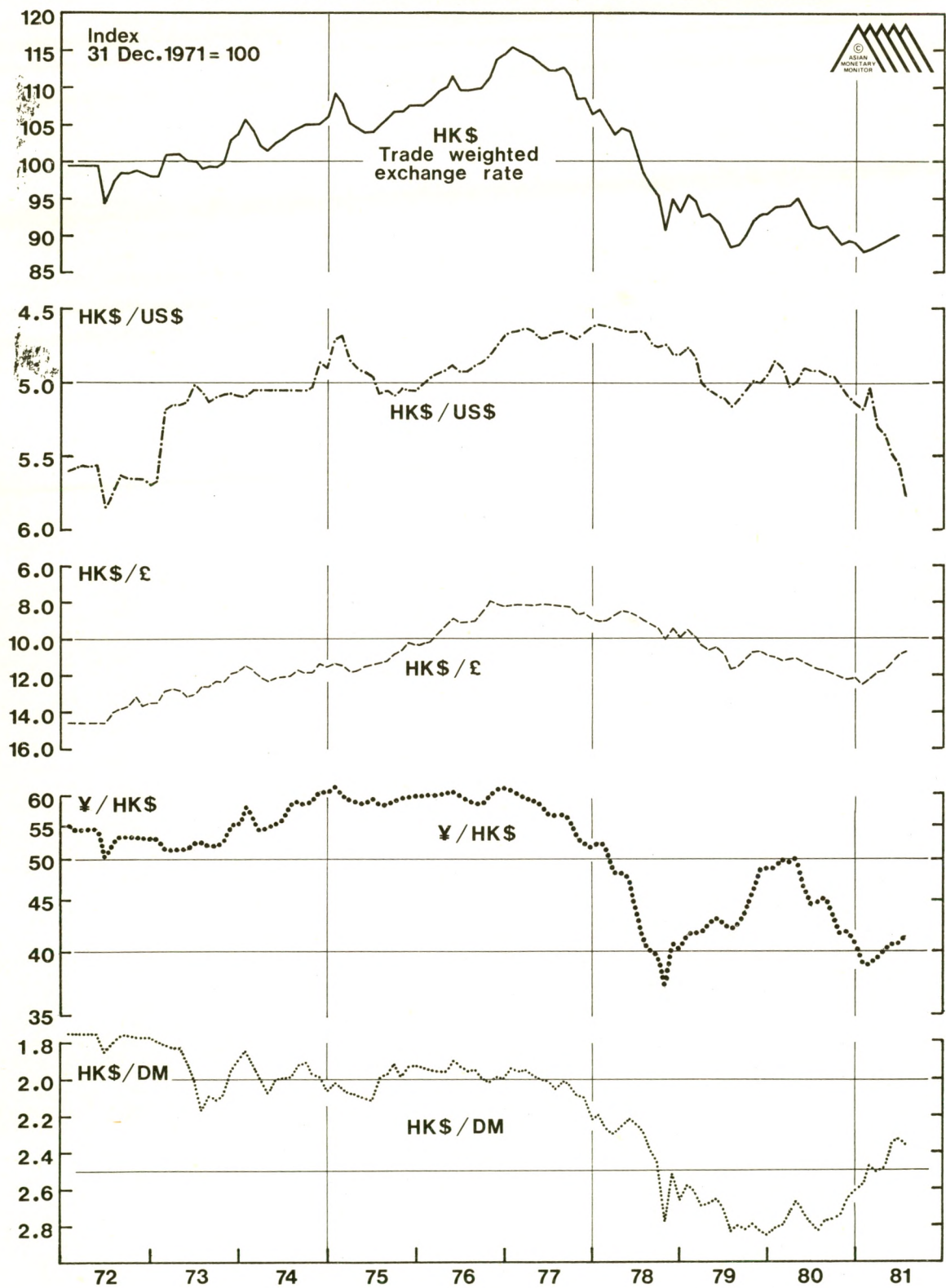
Summary and Conclusions

- 1) The diversity of opinion regarding the underlying trend in US interest rates stems from the ambiguous implications of recent economic indicators and the divergence in M1B and credit growth.
- 2) Credit growth suggests continued momentum in the economy this year. This in turn augurs for continued high interest rates. The narrower monetary statistics suggest that the economy will remain basically flat. On this view the short interest rates will decline with inflation providing the Federal Reserve hits its monetary targets.
- 3) Neither monetary or credit analysis suggests that the US economy will enter a fully fledged recession this year, in spite of very high interest rates. The reasons for this are:
 - a) The Federal Reserve's erratic policy has actually produced rather high monetary growth on a year-on-year perspective.
 - b) Falling inflation. This mitigates the Federal Reserve's supposedly restrictive stance. Recessions are typically associated with cyclical peaks in inflation.

- c) Credit availability. The mechanisms whereby rising rates brought about a restriction in credit availability are no longer in place.
- 4) The lack of a recession implies that interest rates probably will not go significantly and sustainably lower.
- 5) Two factors, however, would induce a move to sustainably lower rates.
 - a) An increase in the savings rate. The yield on financial assets clearly encourages this, and it is obviously what Reagan hopes will occur (aided by tax cuts) since it implies lower rates without a recession.
 - b) High rates and deteriorating balance sheets could induce serious bankruptcies and a credit crunch. Sharply higher interest rates would then presage a recession and ultimately much lower rates.
- 6) Lower inflation is a necessary, but not sufficient, prerequisite for lower interest rates.

HONG KONG

CHART 1: EXCHANGE RATE OF THE HONG KONG DOLLAR



HONG KONG

CURRENCY ON THE SKIDS

The value of the Hong Kong dollar against the US dollar has plunged in recent months. From a level of HK\$5.37 in March this year, the Hong Kong dollar has skidded almost without interruption to nearly HK\$6.00 per US dollar. To some extent the weakness of the Hong Kong dollar against the US dollar simply reflects the general strength of the US currency against all other currencies. Hence in Chart 1 the Hong Kong dollar has been rising against the Pound, against the Yen, and against the Deutsche Mark for much of this year. But the currency's trade-weighted index has fallen inexorably since its peak in late 1976/early 1977 to its lowest levels since the base-date of the trade-weighted index in December 1971.

From the time of the Smithsonian Conference in December 1971 until June 1972 the Hong Kong dollar was pegged to sterling. From July 1972 until November 1974 the currency was pegged to the US dollar (with an upward revaluation on February 15th 1973). During the first three years shown in Chart 1, therefore, the currency was not free to reflect economic forces and its trade-weighted value was more a by-product of the policy of pegging against other currencies than an economically significant price or value in its own right.

However, after the Hong Kong dollar was floated in November 1974 the situation changed. The appreciation or depreciation of the trade-weighted index became a meaningful independent measure of the relative performance of the Hong Kong currency against other currencies in a world of generally floating exchange rates, rather than a reflection of the performance of the currency (sterling or the US dollar) to which the Hong Kong dollar was pegged.

In the first three years after floating the performance of the Hong Kong dollar on this trade-weighted exchange rate basis was pretty good. The currency generally held its own or appreciated against other major currencies. It was only in late 1977 and then in 1978 that the Hong Kong dollar began to weaken significantly against other currencies. Throughout the period 1974-78 the Hong Kong dollar remained close to the US dollar in terms of its foreign exchange value, and therefore the fall in the trade-weighted exchange rate index can be viewed largely as a reflection of the enormous strength of the yen, the DM and Swiss Franc against the US dollar between mid-1977 and November 1978.

In other words, during the early years of floating the Hong Kong currency was in the US dollar camp, with changes in its value largely reflecting changes in the international value of the US dollar. Recently, however, the Hong Kong currency has moved sharply downwards against the US dollar, and although it has strengthened somewhat against sterling and the Deutsche Mark, the trade-weighted exchange rate has weakened to near-

record lows. Thus the Hong Kong dollar appears at last to have broken away from its position as a US-dollar linked currency in the perception of traders and investors.

In the light of this more variable relationship with the US dollar and the continuing variability of the relationship between the Hong Kong dollar and other currencies it would seem desirable to have some idea of what determines the trade-weighted value of the Hong Kong dollar in a fundamental sense. The theory we have experimented with is a variant of purchasing power parity theory which relates changes in the exchange rates between two currencies over the long term to differences in the inflation rates between those two countries. The problem in applying this theory in the short term is that the various indices of inflation commonly used are themselves affected by exchange rate changes, and in addition it is hard to find truly comparable price indices in different countries. One way round these difficulties is to take one step further back in the inflationary process, and look at relative money growth rates rather than relative price changes which are the outcome of differing monetary growth rates.

Applying this idea to explaining the movement of the trade-weighted exchange rate index of the Hong Kong dollar requires compilation of a similar weighted index of money supply growth rates for Hong Kong's main trading partners. Although this is feasible, we cut short this process in two ways - first by using the money supply growth rates of just five major countries (which are also large trading partners of Hong Kong), and second by weighting them according to the size of their GNPs rather than the amount of trade they actually did with Hong Kong. It is probable that, assuming all the data could be readily obtained, the trade-weighted index of money supply growth rates would not be significantly different from the results we actually obtained. (See Chart 2.)

Before describing the quantitative results it should be mentioned that we have not been able to establish any significant relationship between Hong Kong's trade balance and short term movements of the currency. In Chart 2 the trade balance is shown as a ratio to the value of total trade. If the invisible and capital accounts (data for which are not collected in Hong Kong) were assumed to remain unchanged, one would expect the strength of the currency to vary directly with the size of the trade account surplus or deficit. However as Chart 2 shows, there are at least as many upward spikes in the trade balance/total trade ratio coinciding with strength in the trade-weighted index as there are downward spikes. Without more knowledge of the invisibles, capital movements and official transactions it does not seem feasible to investigate any further the relationship between movements of the currency and the overall or partial balance of payments.

The only alternative is to use proximate indicators which will necessarily be less useful over the shorter term, but which may yet shed some light on the long term relationships involved. For this purpose we have taken the ratio of monetary

HONG KONG

CHART 2: DETERMINANTS OF THE TRADE-WEIGHTED EXCHANGE RATE INDEX

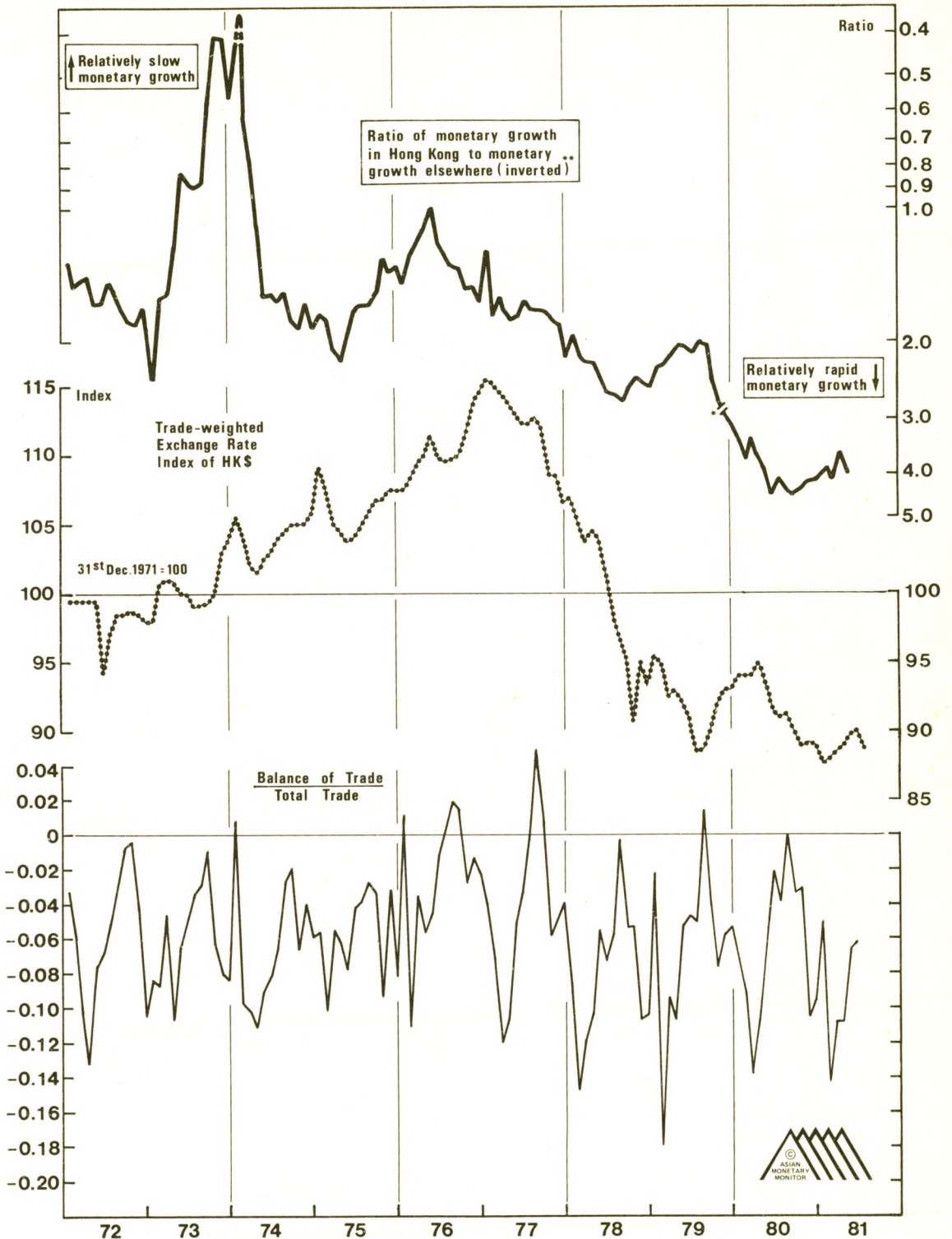


CHART 3: DETERMINANTS OF THE TRADE-WEIGHTED EXCHANGE RATE INDEX



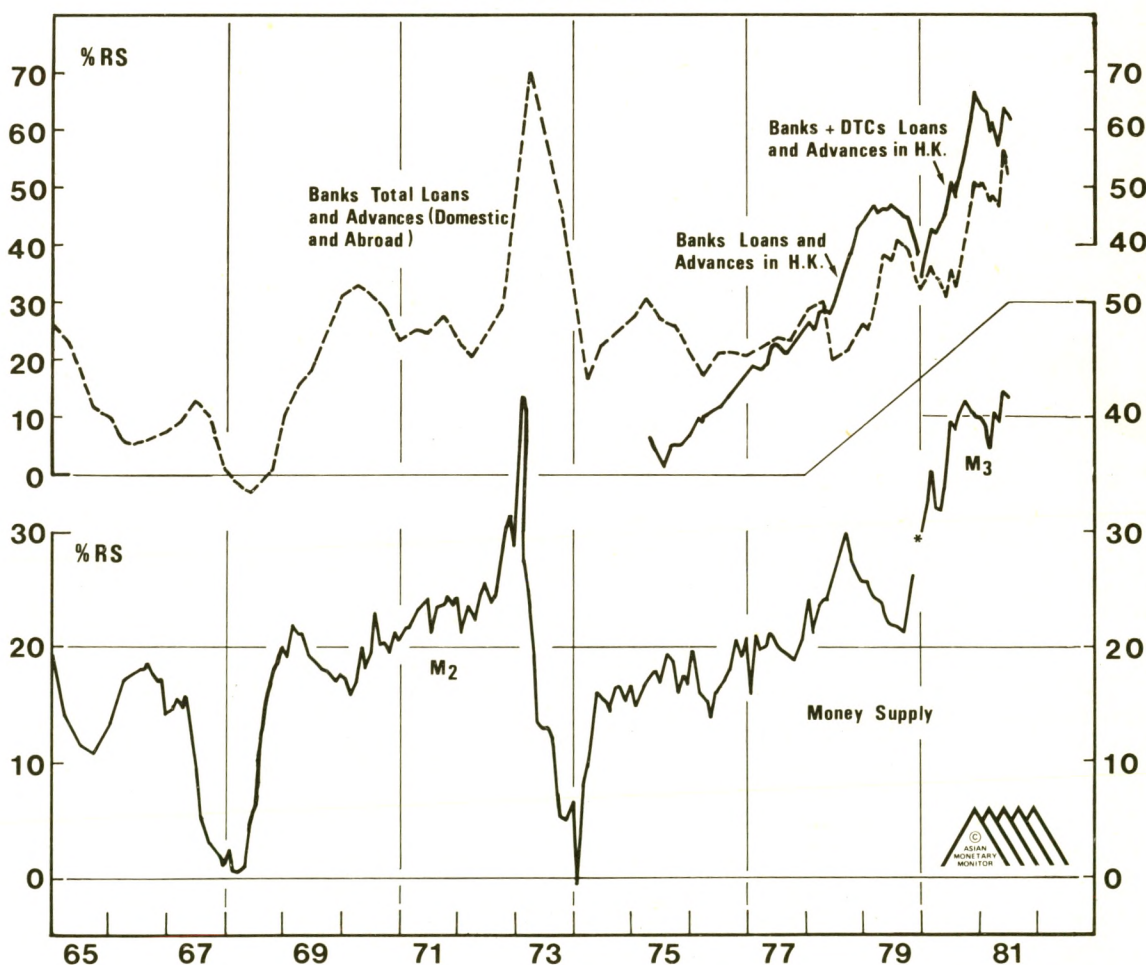
growth in Hong Kong to monetary growth in five major countries and divided the period from 1971 to the present into four sub-periods, taking periods starting and finishing six months later in each case for the trade-weighted exchange rate index. Taking the average values for the money growth ratios and for the weighted exchange rate index for each sub-period gives the results tabulated below.

Average Ratio of Money Growth in Hong Kong to Money Growth in 5 Major Countries		Average Trade-Weighted Exchange Rate Index of HK\$ in periods starting 6 months later		Percentage Appreciation or Depreciation
Jan 72 - Jun 73	1.525	Jul 72 - Dec 73	99.68	-
Jul 73 - Jul 76	1.314	Jan 74 - Jan 77	107.08	+ 7.4%
Aug 76 - Dec 79	2.054	Feb 77 - Jun 80	99.82	- 6.8%
Jan 80 - Dec 80	4.010	Jul 80 - Jun 81	89.33	-10.5%

Chart 3 shows these subperiod averages as steplike lines on the same underlying data as in Chart 2. In the period July 1973-July 1976 the money supply in Hong Kong grew relatively more slowly than it did in January 1972-June 1973. In the 6-month trailing period January 1974-January 1977 the Hong Kong dollar appreciated by 7.4% compared with the period July 1972-December 1973. Thus the mysterious strength of the Hong Kong dollar over much of the January 1974-January 1977 period could be explained as a consequence of the relatively slow money growth in Hong Kong over the July 1973-July 1976 period.

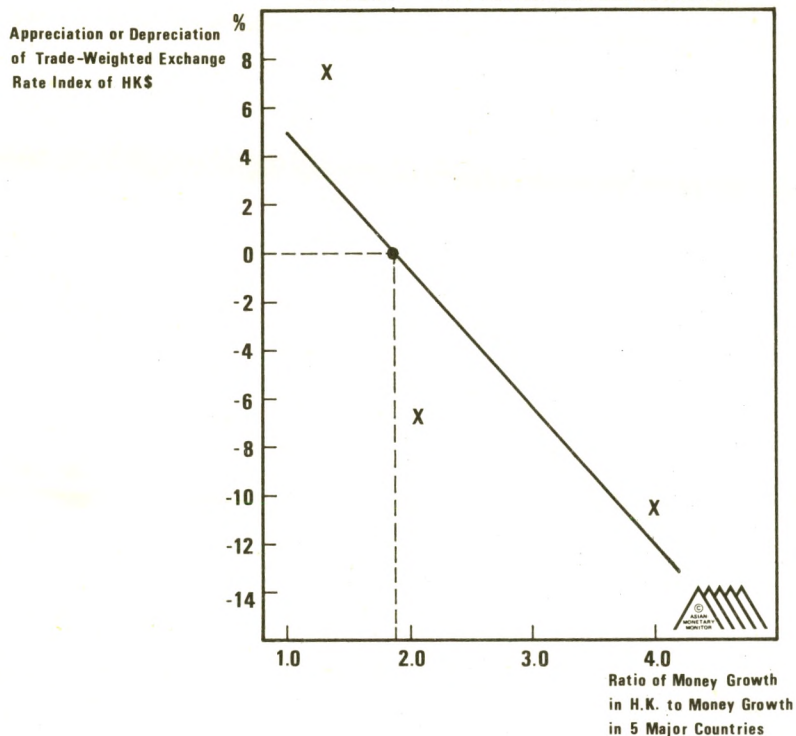
From its peak in January 1977 the trade-weighted index fell steeply without much pause until the turnaround in the fortunes of the US dollar in the autumn of 1978. It is also true that the monetary growth rate in Hong Kong had accelerated somewhat so that from a trough of 1.1 times the money growth rate elsewhere it had accelerated to almost 3 times the money growth in 5 major countries by late 1978.

HONG KONG
CHART 4: MONEY AND CREDIT GROWTH



*Change of M₂ to M₃ series

CHART 5: HONG KONG
RELATION BETWEEN MONEY GROWTH AND
CURRENCY APPRECIATION/DEPRECIATION



Again, therefore, the pattern of monetary growth - in this case acceleration - was consistent with the currency movement - depreciation by 6.8% compared with its average level in January 1974-January 1977.

Shifts of deposits from banks to deposit-taking companies (DTCs) make the M2 statistics for 1979 somewhat misleading, so from January 1980 onwards the charts shifts to a new monetary data series (M3). The average growth rate of money in Hong Kong over the period January 1980-December 1980 accelerated again to just over 4 times the growth rate of money in the five major countries chosen for comparison. Once again the exchange rate index shows a further depreciation in the subsequent 6-month trailing period July 1980-June 1981 - this time by 10.5%.

The question is, what is an appropriate money growth rate in Hong Kong in order for the weighted exchange rate index to remain stable? The data quoted above give us sufficient information to answer that question, at least approximately. By plotting the average ratio of money growth in Hong Kong to the money growth in 5 major countries against the percentage appreciation or depreciation of the weighted exchange rate index in the corresponding 6-month trailing period we have been able to calculate the line which best fits these data points. The result is shown in Chart 5. Now, by starting at the point on the vertical axis which shows zero appreciation or depreciation of the currency we can follow the dashed line

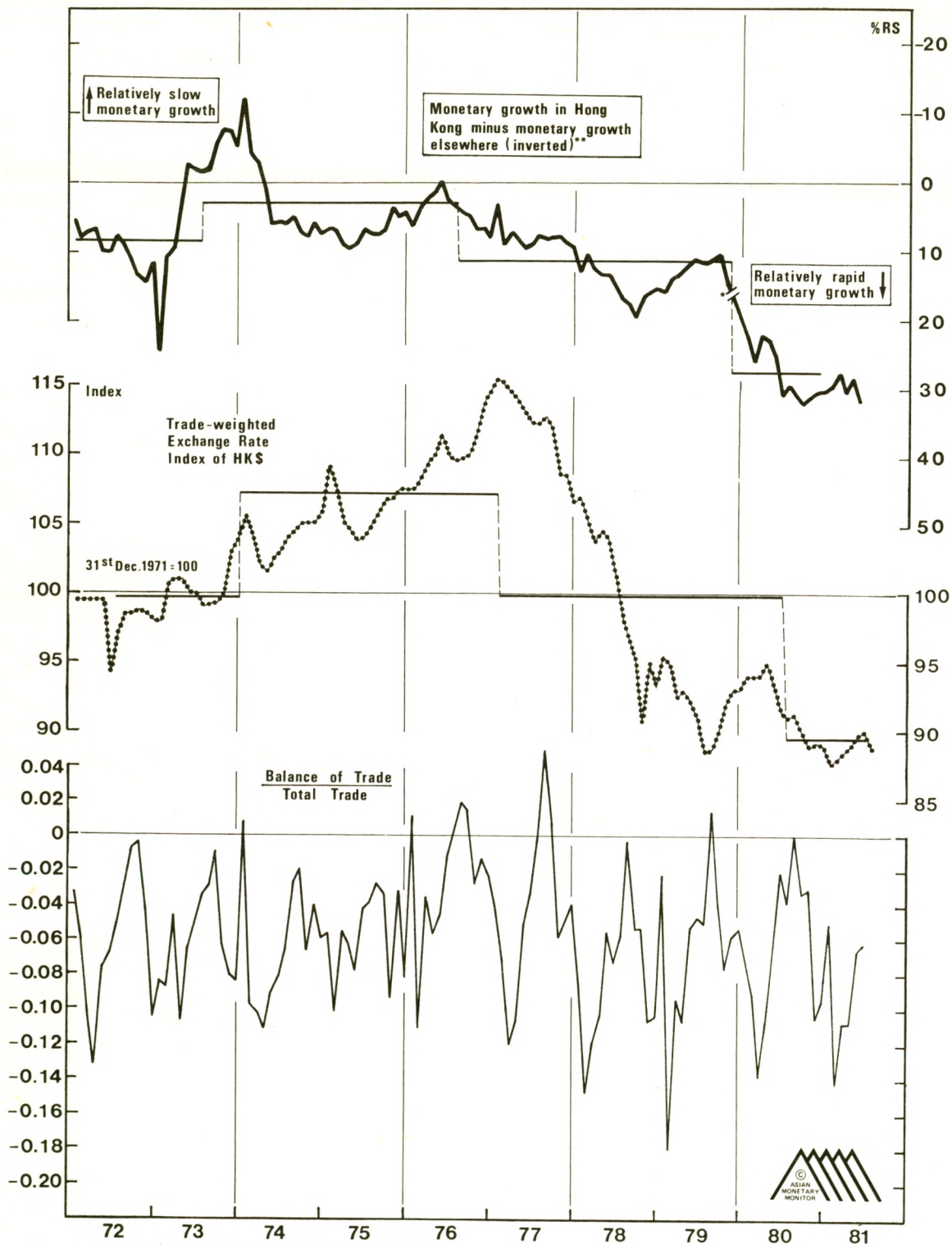
across to the point on the fitted line and then down from the point of interception to the horizontal axis which indicates the relative money growth rate ratio required for stability of the weighted exchange rate index - about 1.9. In other words, in order for the Hong Kong dollar's weighted exchange rate to be stable on average over an extended period of time - say, two years - the money supply in Hong Kong should not grow faster than 1.9 times or about twice the weighted average money supply growth rate of its major trading partners.*

This number seems reasonable to us in that real growth rate of Hong Kong's economy is about twice the average real growth rate of Japan, Germany, the USA, Britain and France, so we would expect the permissible monetary growth rate to be that much higher in Hong Kong.

SUMMARY AND FORECAST: For structural reasons explained in previous issues of AMM the supply of money in Hong Kong (or its near-counterpart, the volume of bank credit) continues to grow at a very rapid rate. In the past year the rate of money growth in Hong Kong has averaged four times the rate of money growth in five major trading partners, or about twice the rate of growth which would seem to be compatible with stability in the trade-weighted exchange rate index. (A money growth rate in Hong Kong of 1.9 times the weighted average growth rate of money in the same five major trading partners was found to be compatible with stability in the trade-weighted exchange rate index.) Now that the Hong Kong dollar is no longer so closely identified with the US dollar bloc of currencies its movements can be expected to be more independent of the American currency, but this also suggests that investors and traders will pay more attention to the impact of such local factors as monetary growth, the trade balance and inflation in determining the external value of the Hong Kong dollar. Until structural reforms in the banking system are implemented which enable the authorities either to regulate directly the quantity of base money (and hence the total money supply) or to maintain a particular exchange rate (as in the pre-1972 system), there is only a remote chance that the Hong Kong currency will retain its purchasing power. Long term investors would be therefore well-advised to hedge their Hong Kong dollar investments on a continuous basis against whichever major currency they estimate to be the strongest, while borrowers would be wise to maintain their liabilities in Hong Kong dollars. High interest rates in Hong Kong provide no assurance that the local currency will stabilise, being as much a symptom of inflation as a sign that funds are in short supply. Whatever the destiny of Hong Kong as an international financial centre, the medium and long term outlook for the local currency is for continuing weakness.

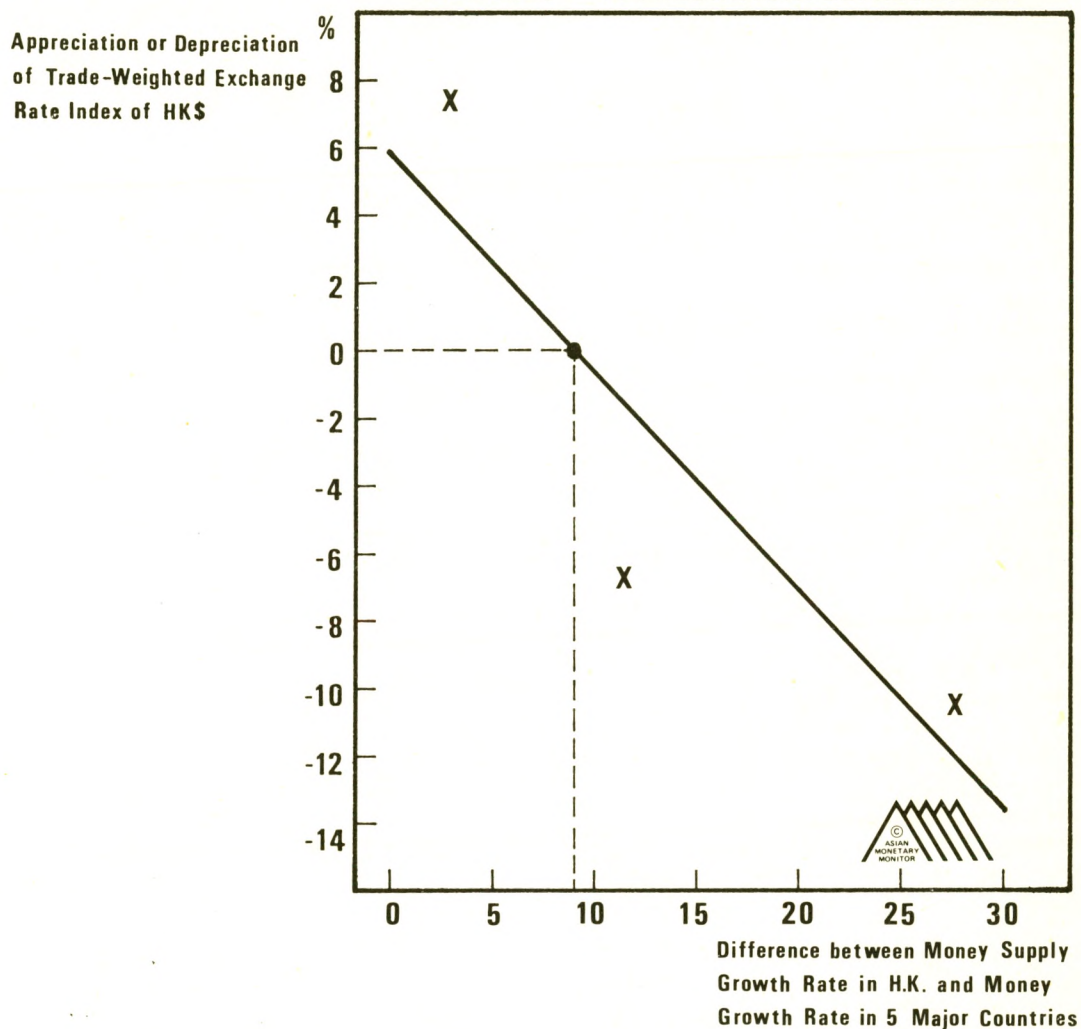
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* See appendix for derivation and assumptions.

HONG KONG
CHART 6: DETERMINANTS OF THE TRADE-WEIGHTED EXCHANGE RATE INDEX



- Change in Hong Kong data series from M2 to M3
- ** (Money growth in Hong Kong) - (Weighted average of money growth in USA, W. Germany, Japan, UK and France)

CHART 7: HONG KONG
RELATION BETWEEN MONEY GROWTH AND
CURRENCY APPRECIATION/DEPRECIATION



Appendix 1

=====

Conducting the same exercise for the difference between the money growth rate in Hong Kong and the money growth rate in 5 major countries gives similar results, this time in terms of the number of percentage points by which money growth in Hong Kong can afford to exceed money growth elsewhere. The recent record shows that average money growth in the 5 major countries has been around 11%. The chart above suggests that money supply growth in Hong Kong could afford to be 9 percentage points higher (i.e. around 20% per annum) without producing any long term depreciation of the trade-weighted exchange rate. As a caveat it should be pointed out that money growth in the USA and Britain can be expected to be significantly lower over the next two years than their respective averages in the past few years, and this would obviously lead to a lower weighted average figure for the five major countries. That in turn would mean that for the trade-weighted index of the Hong Kong dollar to be stable the local monetary growth rate would have to be reduced to below 20%.

Appendix 2

=====

Derivation of Relation between Money Growth and Currency Appreciation/Depreciation

We start with a quantity theory identity for two countries:

$$\text{Country (1) } MV = Py \quad ; \quad \text{Country (2) } M'V' = P'y'$$

where M is the stock of money, P is the general price level, y is real income per annum, and V (income velocity) is the ratio of ~~real~~ income per annum (Py) to the money stock, M; and similarly for country (2). *nominal*

Divide (1) by (2)

$$\frac{MV}{M'V'} = \frac{Py}{P'y'}$$

$$\frac{M}{M'} = \frac{P}{P'} \left(\frac{V'}{y'} \cdot \frac{y}{V} \right)$$

Assume the factors in parentheses remain constant [k] . Expressed in terms of growth rates we have:

$$(\dot{M} - \dot{M}') = (\dot{P} - \dot{P}') + [\dot{k}]$$

i.e. { Difference in money supply growth rates } should explain { Differences in inflation } assuming other factors (real growth, income velocity) remain unchanged.

and { Differences in inflation } should explain { Exchange Rate changes } assuming other factors remain unchanged.

Hence,

{ Relative money supply growth rates } should explain { Exchange Rate changes } assuming other factors remain unchanged.

SOUTH KOREA

AN INCIPIENT RECOVERY

Unlike most economies of the Asian Pacific Rim, the Korean economy has been turning upwards in 1981 following a recession in 1980. In contrast, most of the economies of South East Asia, including Australia, have been enjoying the late stages of a business cycle expansion during 1981 - in most cases an extension of the 1979-80 boom. The only major economy having a similar profile to Korea in the pattern of its business activity is Japan where industrial production slowed down progressively through most of 1980 and is now picking up slowly.

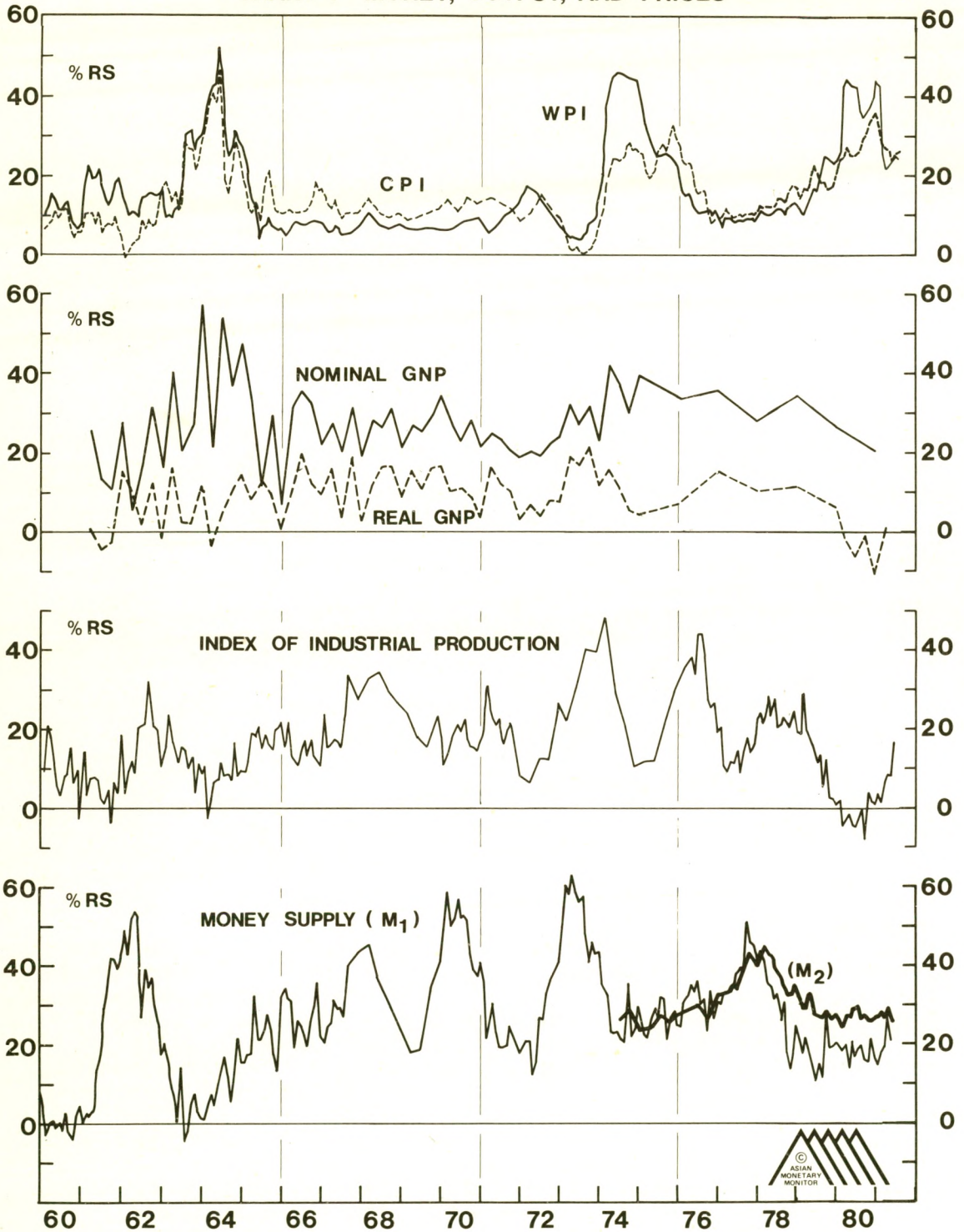
Another interesting contrast between the experience of other Asian economies and Korea is to be found in the financial markets. Whereas stock markets in Hong Kong, Singapore and the commodity-producing economies like Malaysia and Australia have generally experienced a spluttering extension of the boom in 1980 with quite sharp ups and downs as the potential for further economic expansion in the present cycle became increasingly dubious and liquidity tightened against a background of a deteriorating trade balance and rising domestic interest rates, Korea has seen a decisive recovery in its stock market thanks in part to the restoration of domestic and international confidence in the new administration, but also to the 1979-80 shake-out. This has enabled the economy to build a new base from which a sustainable expansion can be envisaged.

Following the devaluation of the Korean Won in January 1980 the authorities announced that monetary growth would be targetted at 25% p.a. In fact M2 has grown just slightly in excess of this rate since that time, and M1 has averaged just below 20% p.a. In an economy with a very strong growth potential (approaching 10% p.a. in real terms), it is probable that such monetary growth rates could be compatible with quite modest rates of inflation of around 12% p.a. In the past two years the actual inflation has been considerably in excess of this as a result of the excessive monetary expansion in 1977-78 and the direct effects of the devaluation itself. Thus in 1980 wholesale prices rose by 38.9% on average for the year as a whole, while consumer prices (which generally lag somewhat behind wholesale prices) rose on a year-to-year basis from 24% in January to 36% at their peak in December 1980.

The recession in Korea in 1980 owed much to the domestic inflation which eroded purchasing power while the Bank of Korea did not provide a sufficient compensating boost to nominal spending power but kept monetary growth in check. On the external side exports (in US\$) slowed down from an average 28% growth in 1977-78 to 16% in 1980. The extent of the domestic slowdown is reflected in the abrupt slowdown in imports from an average 37% growth rate in 1978-79 to just below 10% in 1980. This year both exports and imports have picked up,

SOUTH KOREA

CHART 1 : MONEY, OUTPUT, AND PRICES



and domestic industrial production and GNP have followed suit.

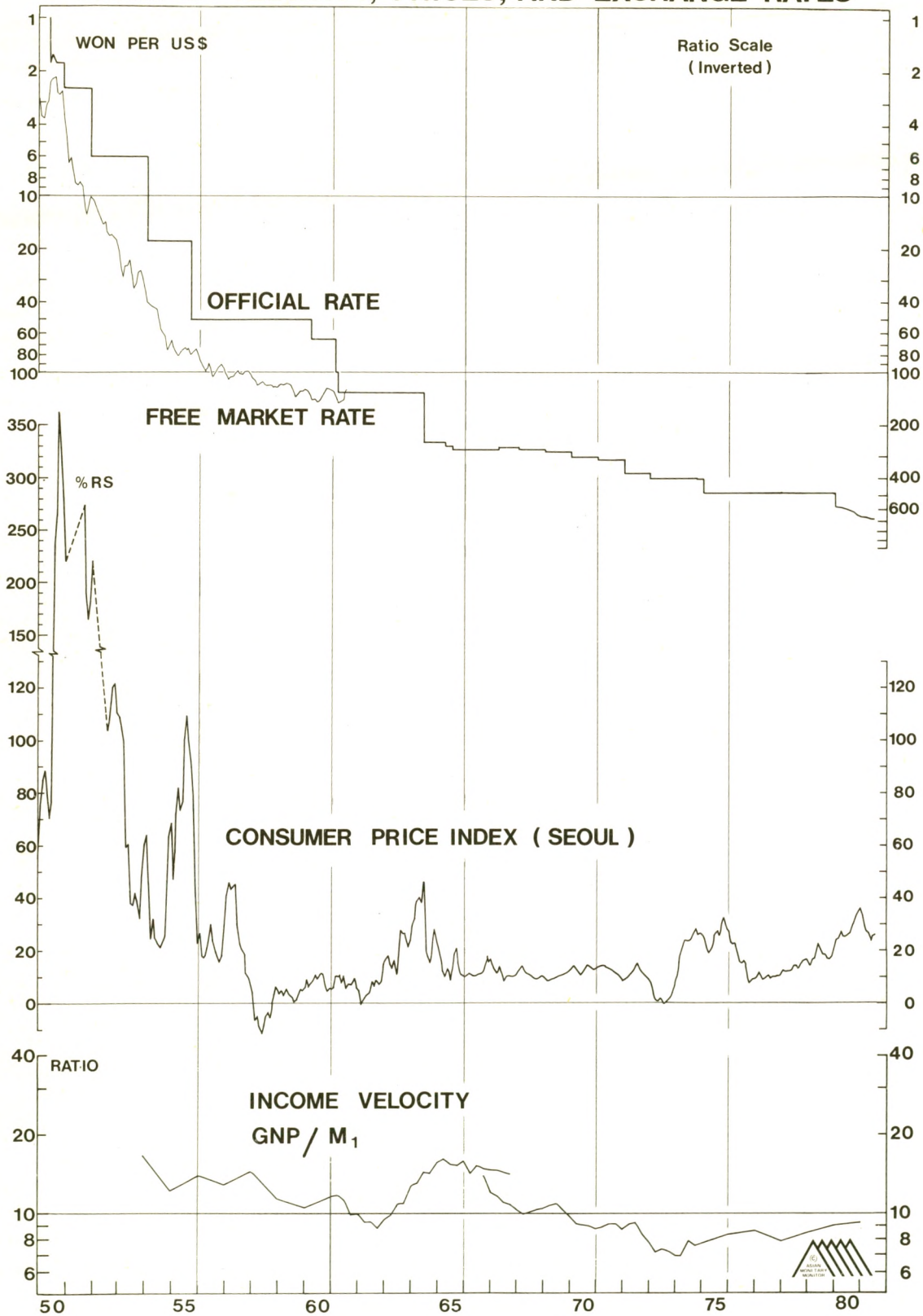
Korea's Trade Statistics				
(Customs Clearance Basis; US\$ millions)				
	Exports	% Change	Imports	% Change
1976	7,715.1	51.8	8,773.6	20.6
1977	10,046.5	30.2	10,810.5	23.2
1978	12,710.6	26.5	14,971.9	38.5
1979	15,055.5	18.4	20,338.6	35.8
1980	17,504.9	16.3	22,291.7	9.6
1981 Jan.-May	8,180.7	26.6	10,575.0	15.7

Having fallen sharply in the last two quarters of 1980, Korea's real GNP began to recover in the first quarter of 1981, growing by 1.2% in real terms compared with the first quarter of 1980, and compared with year-to-year declines of 0.8% and 10.6% in the third and fourth quarters of 1980 respectively. Initial estimates for the second quarter of 1981 suggest that the recovery has continued, picking up to reach a year-to-year growth of between 3 and 4% in real terms. The two main contributing elements have been the boost in export performance (merchandise trade recorded a 23.4% increase, while imports increased by 18.7%) and the recovery in domestic personal consumption expenditure which is once again in positive territory. Fixed capital investment is still not expanding, reflecting the availability of surplus capacity from last year's slump in the economy, and a continuing pause in the construction industry. The government sector has been modestly restrained, with government expenditure on current account (goods and services as opposed to capital items) being down on a year-to-year comparison basis.

All in all there are signs of a return to health in the real economy, in trade, and in the domestic financial markets. The only two important areas in the macroeconomic picture where improvements still have to be made are inflation, and, closely linked to that, the external value of the currency. Given the government's targets for monetary growth, and remembering the historical willingness of South Korean governments to allow the currency to depreciate (see Chart 2) and to tolerate a much higher rate of domestic inflation than many other nations would permit, it seems likely that the inflation rate will not fall below double digits. Indicative of its lenient attitude the government has publicly stated that it will try to restrict commodity price rises to the 20-25% range, a target which ought to allow ample latitude for error in a year when world commodity prices are likely to be generally weak against a background of sluggish levels of economic activity in the leading industrial nations.

SOUTH KOREA

CHART 2 : VELOCITY, PRICES, AND EXCHANGE RATES



FORECAST: Looking further out the Korean Development Institute and the Economic Planning Board have designed a medium-term economic plan which aims at slowing the rate of inflation, bringing it down to a single-digit rate by 1983. For this purpose they suggest a monetary growth target of 18% for M1, and a target for M2 of 24.5%, not significantly different from the current calendar year's targets. By 1983 they expect the Won to have fallen to about 720 per US dollar. With the won already in the 680-690 range we think it probable that the 720 target for 1983 will be reached by mid-1982, and therefore the inflation rate will not come down into single digits without a tighter grip being placed on monetary growth. Like so many economies Korea seems unwilling to sacrifice economic growth even for a temporary period to achieve price stability. Thus while the present economic upturn gathers momentum it is unlikely that the inflation rate will decline very much below 15%, and there will in any case be a tendency for the inflation to be aggravated by periodic downward movements in the exchange rate.

WHEN WILL FOREIGN PORTFOLIO INVESTMENT IN KOREA BE PERMITTED?

The Official View as Explained by Finance Minister Lee
at a Press Conference in Seoul, January 14th, 1981.

Securities investment by foreign concerns in S. Korea will be allowed on a limited scale through fiduciaries, possibly between this and next year, as a preparatory step to the full liberalization of capital flows into and out of the local money market, tentatively timetabled for the early part of the 1990s.

To begin with the government plans to authorize the nation's investment trust firms to issue beneficial certificates, exclusively intended for foreign investors, starting from this year.

In a major policy announcement, Minister of Finance Lee Seung-yun said yesterday (January 14th, 1981) that the government is now working on concrete plans for creating an international investment trust system to achieve a limited opening of the domestic capital market.

Now that the government has already decided on a gradual step-by-step liberalization of the domestic securities market, a detailed program for the foreign capital-oriented investment trust system will be mapped out by the end of the year, Lee disclosed.

According to the Finance Ministry's broadly-framed plan, two possibilities are currently under study:

(1) The possibility that local investment trust companies issue beneficial certificates (B/Cs) overseas via overseas-based foreign agents.

(2) And the other possibility that local trust companies or securities corporations establish offshore joint venture companies with leading foreign securities firms, through which B/Cs will be sold to foreign investors.

Regarding the necessity for such fiduciaries, the Finance Minister explained that this indirect system will help minimize the expected impact on the local market in the early stages of its opening foreign capital, while protecting the nation's enterprises from interference in their management by foreign shareholders.

In addition, if implemented, the international investment trust system will help secure for S. Korea a stable supply of foreign industrial capital through more diversified sources, and contribute toward laying the groundwork for the nation's future advancement abroad in this area, Lee said.

Meanwhile, the Finance Ministry believes that the first alternative has the advantage of reducing the possible impact on the local capital market because it puts more limits on foreign participation via the process of issuing the beneficial certificates in overseas markets. The

issuance and operation of this type of security is possible even under the existing legal system.

On the other hand, the second choice is thought to have the advantage that the overseas sales and other business activities related to the securities will be easier because they are floated directly in foreign markets and depend on the name value and creditworthiness of the foreign joint venture partners.

But the Finance Ministry contends that if the nation favors the second choice, a proper set of regulatory measures must be worked out as it implies direct investment by institutional investors with foreign connections.

Those measures will be concerned with the scale of the Korea Fund to be operated by the joint venture interest, the kind of securities whose acquisition by foreign investors will be permitted, and the remittance of returns from investment.

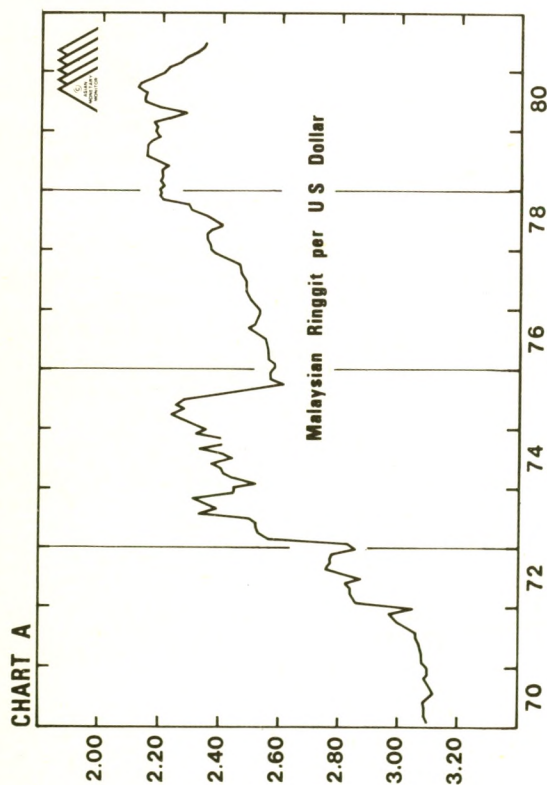
For the early introduction of the system, the government is now consulting with the International Finance Corp. and advanced countries with much experience in this field.

However, the proposed institutionalization of the international financing method does not mean any immediate wide opening of the domestic capital market, it is pointed out.

The government's long-term blueprint envisages four stages of development toward the eventual market opening viz:

1. The period for laying the groundwork (up to 1984)
2. Allowing limited direct equity investment by foreign concerns (around 1985)
3. The full-scale allowance of direct equity investment by foreigners and the issuance of local securities overseas (in the late 1980s)
4. The full liberalization of capital movements (in the late 1990s).

(adapted from a report in the Korea Herald, January 14th, 1981.)



The Malaysian currency has exhibited what at first glance is uncharacteristic weakness against the US dollar. This year the Ringgit has declined from M\$2.20 in January to around M\$2.37 at present. Of course this depreciation has been shared by other currencies to a greater or lesser degree, and in part reflects the fact that the Bank Negara Malaysia manages the Ringgit against a basket of currencies.

Nevertheless, it appears there are growing indications that the Ringgit has lost much of the fundamental strength which led to a steady appreciation during the 1976-1980 period. Two important symptoms of this are the moderate decline in the level of Malaysia's International Reserves, and the dramatic turnaround in the trade balance. After a huge improvement during 1979, Malaysia's trade surplus fell rapidly during 1980. In the main, the deterioration in Malaysia's trade account is due to a significant decline in export growth. During the first quarter of 1980 exports rose 40% from the same period in 1979, but by the end of the year exports had declined by nearly 5%. In so far as this decline is primarily the result of a cyclical fall in the price of Malaysia's major exports, the implications for the longer term trend in the trade account may not be too worrying.

However, what is of concern is the continued high rate of growth of Malaysian imports, which are currently rising at a year-on-year rate of around 25%. High import growth illustrates a more basic reason for caution for the medium term prospects of the Ringgit. A strong demand for imports is one consequence of rising nominal incomes and accelerating monetary growth. Rising inflation is another. After reaching a cyclical trough of 3% in late 1978, consumer prices have risen steadily and increased by more than 10% in the year to May. On the other hand, consumer price inflation in the US has fallen substantially since the beginning of last year. Having reached a peak of 14.7% year-on-year in February 1980, consumer price inflation is now down to 9.4% and is likely to decline further during the remainder of this year. This divergence in inflationary trends in Malaysia and the US implies that the improvement in the Ringgit's general competitiveness evident in 1979 and 1980 (see Chart D) may be reversed. The trends evident in Charts B and E suggest that, given existing relative inflation levels, real aggregate demand in Malaysia may be too strong to maintain the Ringgit-dollar exchange rate at existing levels. This implies that the Ringgit will be vulnerable to further weakness against the US dollar unless there is a downturn in real economic activity.

In fact, the recent decline in monetary growth and generally higher interest rates suggest that some slowdown may occur, but unfortunately for the shorter term outlook for the Ringgit these trends need to be sustained for several months before we may reliably forecast a fall in domestic inflation. For the first time since late 1974 Malaysia has a higher rate of inflation than the US. Unless this situation adjusts rapidly, the Ringgit's reputation as a strong currency will diminish.

M\$/US\$	ACTUAL		FORECAST	
	1980 Q1	Q2	Q3	Q4
FORECAST A				
Actual Range	2.2050-2.3100	2.2725-2.3675	2.60	2.65
FORECAST B			2.30-2.45	2.30-2.50

Forecast A

is based on a simple projection of relative price competitiveness shown on Chart D i.e. the exchange rate necessary to bring US and local price levels into line.

Forecast B

is the most likely range in the absence of some major political or other external disruption.

CHART B
TRADE PERFORMANCE

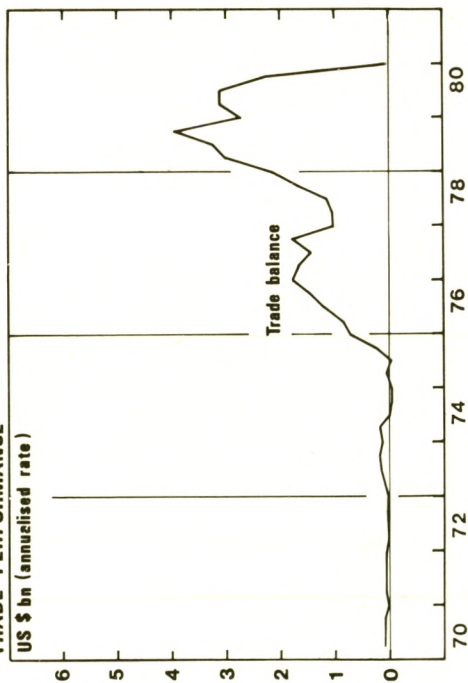


CHART C

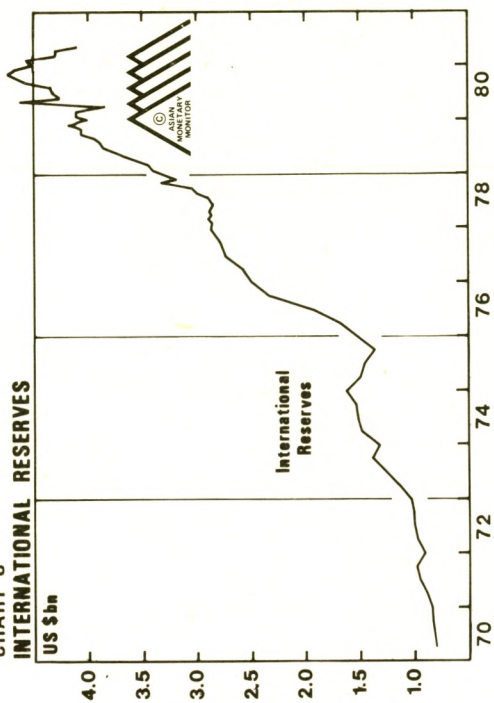


CHART D

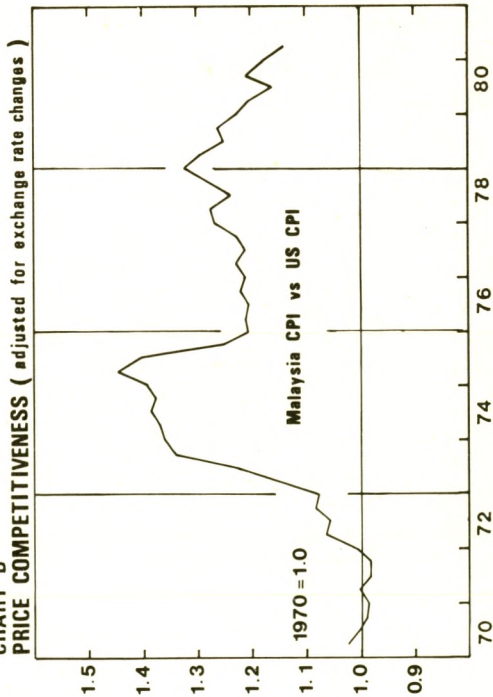
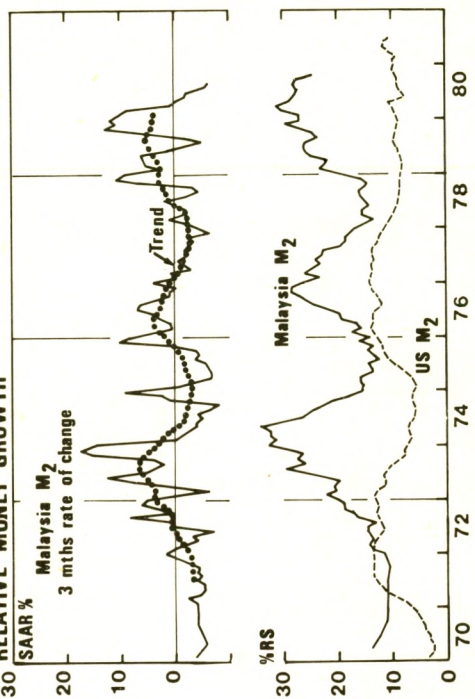
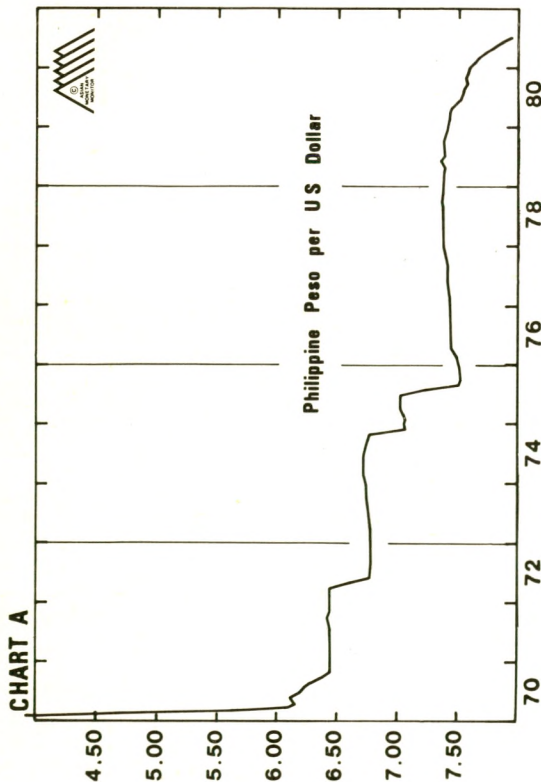


CHART E
RELATIVE MONEY GROWTH



SAAR: SEASONALLY ADJUSTED AT ANNUAL RATE
RS: RATE OF CHANGE OVER SAME MONTH OF PREVIOUS YEAR



A series of moderate, unannounced, depreciations of the Philippine Peso against the US dollar has been a feature of regional currency movements during the last six months. Having maintained the Peso at ₱7.5529 from May 1980 through until February 1981, the Central Bank allowed the rate to slip in three small, but discrete adjustments to its current level of ₱7.943.

Throughout the latter half of the 1970s many analysts warned of the possibility of a large devaluation of the Peso such as last occurred in 1970 when the Peso was devalued by 36% against the US dollar. The basis for this view lay with persistent balance of trade problems (see Chart B) and, more fundamentally, with the wide divergence of inflation rates between the Philippines and the US. In spite of the adjustments to the Peso-dollar rate made in 1974 and 1975, the Peso became increasingly overvalued against the US currency in the latter half of the decade. This is indicated by the upward slope of the line in Chart D.

However, unlike many other countries in South East Asia the fundamental backing to the Philippine currency began to show signs of stabilising towards the end of 1980. The most noteworthy improvement was in inflation. From a recent high of 25.9% year-on-year

in February 1980, consumer price inflation fell sharply to 11.3% year-on-year in March 1981. The external sector also began to pick up as a consequence of a dramatic reduction in import demand. Total imports grew a mere 3.8% in the first quarter of 1981 compared with 31.9% in the corresponding period of 1980. The reduction in the Philippines' trade deficit is shown in Chart B.

The backdrop to the more favourable trends in inflation and the trade balance lies in a severe monetary squeeze engineered by the Philippine Central Bank. M2 growth plummeted from 19.4% in April 1979 to 6.9% year-on-year in May 1980. The contraction in domestic liquidity, although not of a comparable magnitude to the squeeze which occurred in 1974, reduced M2 growth to its lowest level since 1972.

Nevertheless, it is evident ^{from} Chart E that the gains achieved during 1979 and the first half of 1980 have been almost entirely eroded. There has been a surge in monetary growth in the last nine months - probably in part due to the authorities' moves to stem pressure on money markets following a series of financial scandals - with M2 now up more than 25% on a year ago. Unless this large increase in monetary growth is rapidly curtailed the improvements in inflation and the trade deficit will be temporary. Thus although it seems that the Philippines will be able to avoid a large devaluation in the shorter term, the longer range risks are likely to increase. The Peso is likely to remain a fundamentally weak currency.

P/US\$	ACTUAL			FORECAST	
	1981 Q1	Q2	Q3	Q4	
FORECAST A					
Actual Range	7.60-7.77	7.73-7.95	10.8	11.0	
FORECAST B			7.94-8.05	8.00-8.12	

Forecast A is based on a simple projection of relative price competitiveness shown in Chart D i.e. the exchange rate necessary to bring US and local price levels into line. ^{likely}

Forecast B is the most ^{likely} range in the absence of some major political or other external disruption.

CHART B
TRADE PERFORMANCE

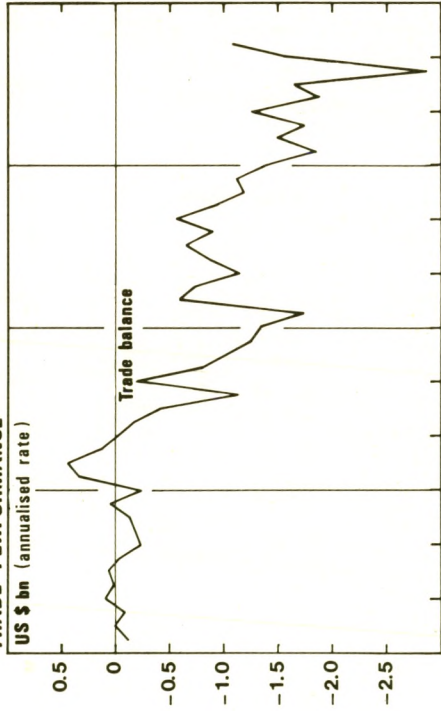


CHART C
INTERNATIONAL RESERVES

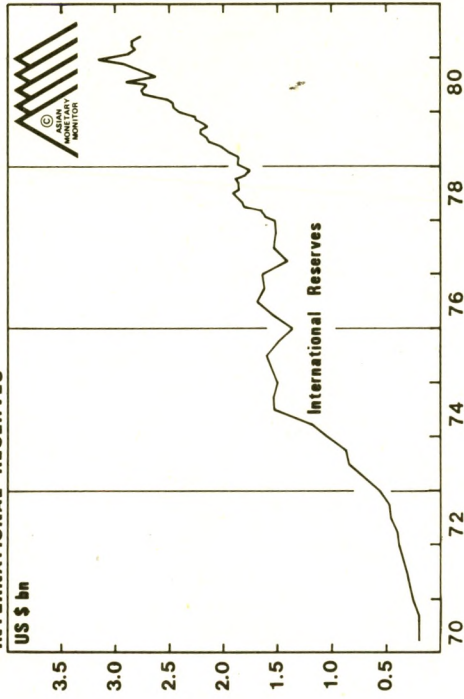


CHART D

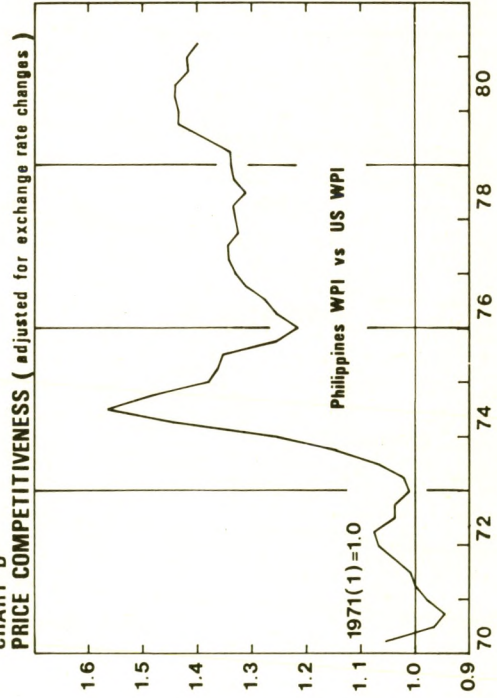
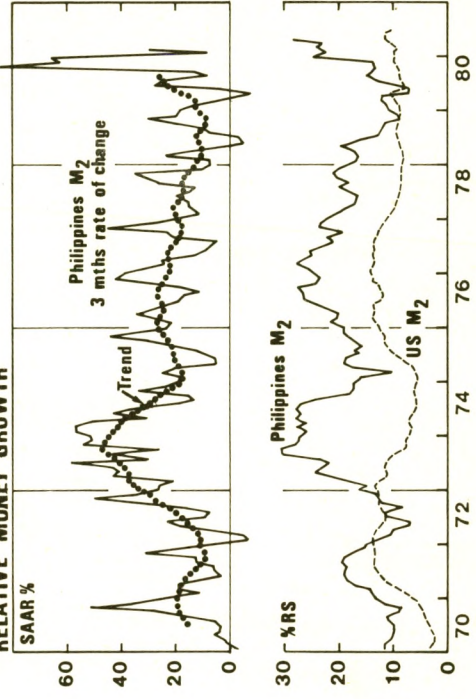
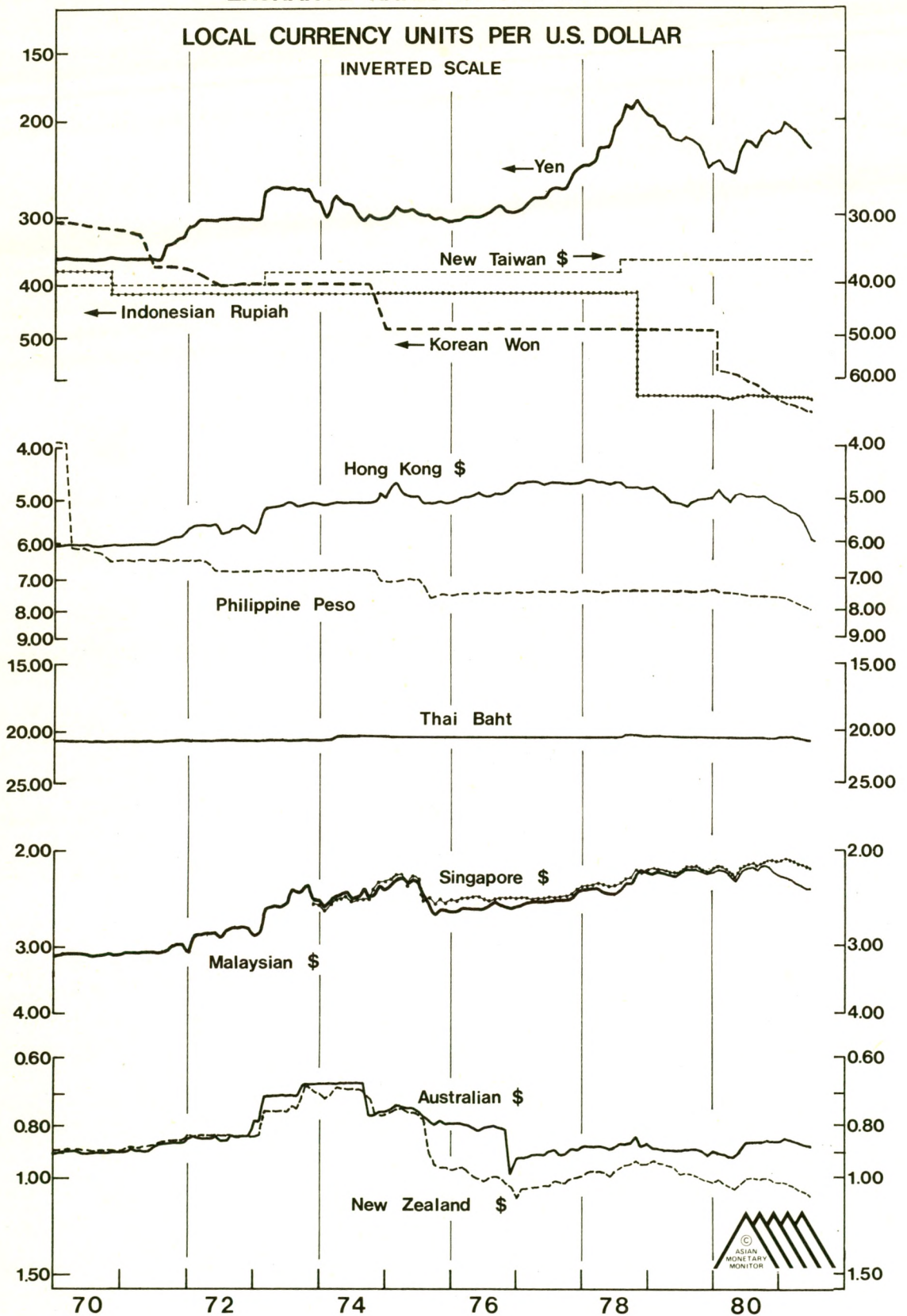


CHART E
RELATIVE MONEY GROWTH



SAAR: SEASONALLY ADJUSTED AT ANNUAL RATE
RS: RATE OF CHANGE OVER SAME MONTH OF PREVIOUS YEAR

EXCHANGE RATES IN THE FAR EAST

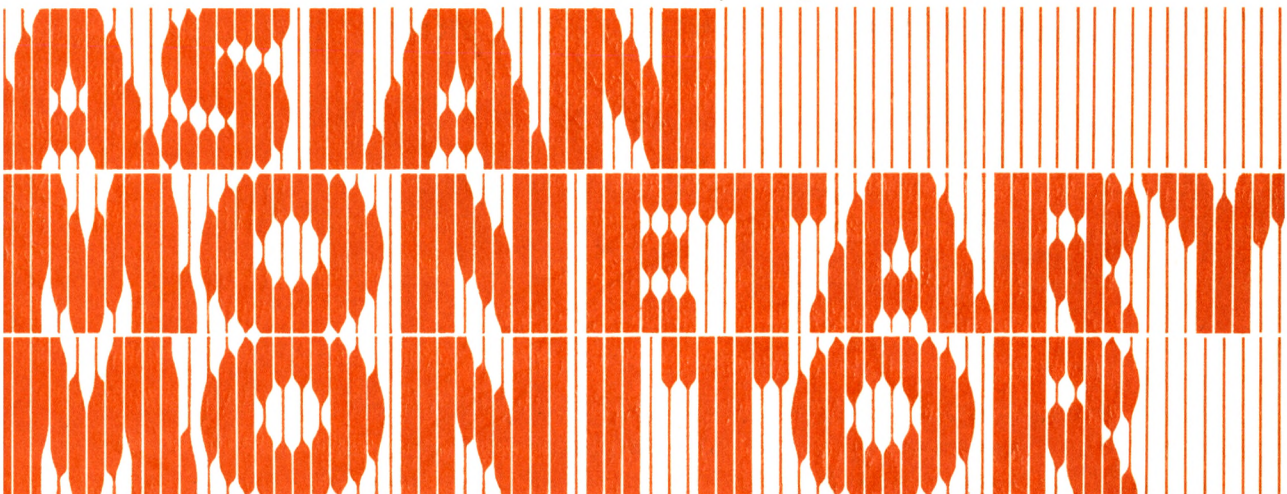




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CONTENTS

Page

AUSTRALIA:

Interest Rates Have yet to Peak.

HONG KONG:

Time to Blow the Whistle.

MALAYSIA:

A Severe Cyclical Downturn.

EXCHANGE RATE FORECASTS:

Australian Dollar

Hong Kong Dollar

New Taiwan Dollar

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Vol. 5 No. 4

July - August 1981

CONTENTS

	Page
AUSTRALIA	
Interest Rates Have yet to Peak.	3
HONG KONG	
Time to Blow the Whistle.	15
MALAYSIA	
A Severe Cyclical Downturn.	35
EXCHANGE RATE FORECASTS:	
Australian Dollar	44
Hong Kong Dollar	46
New Taiwan Dollar	48

KEY TO SYMBOLS USED IN THE CHARTS

% RP - Percentage Rate of change over Preceding period.

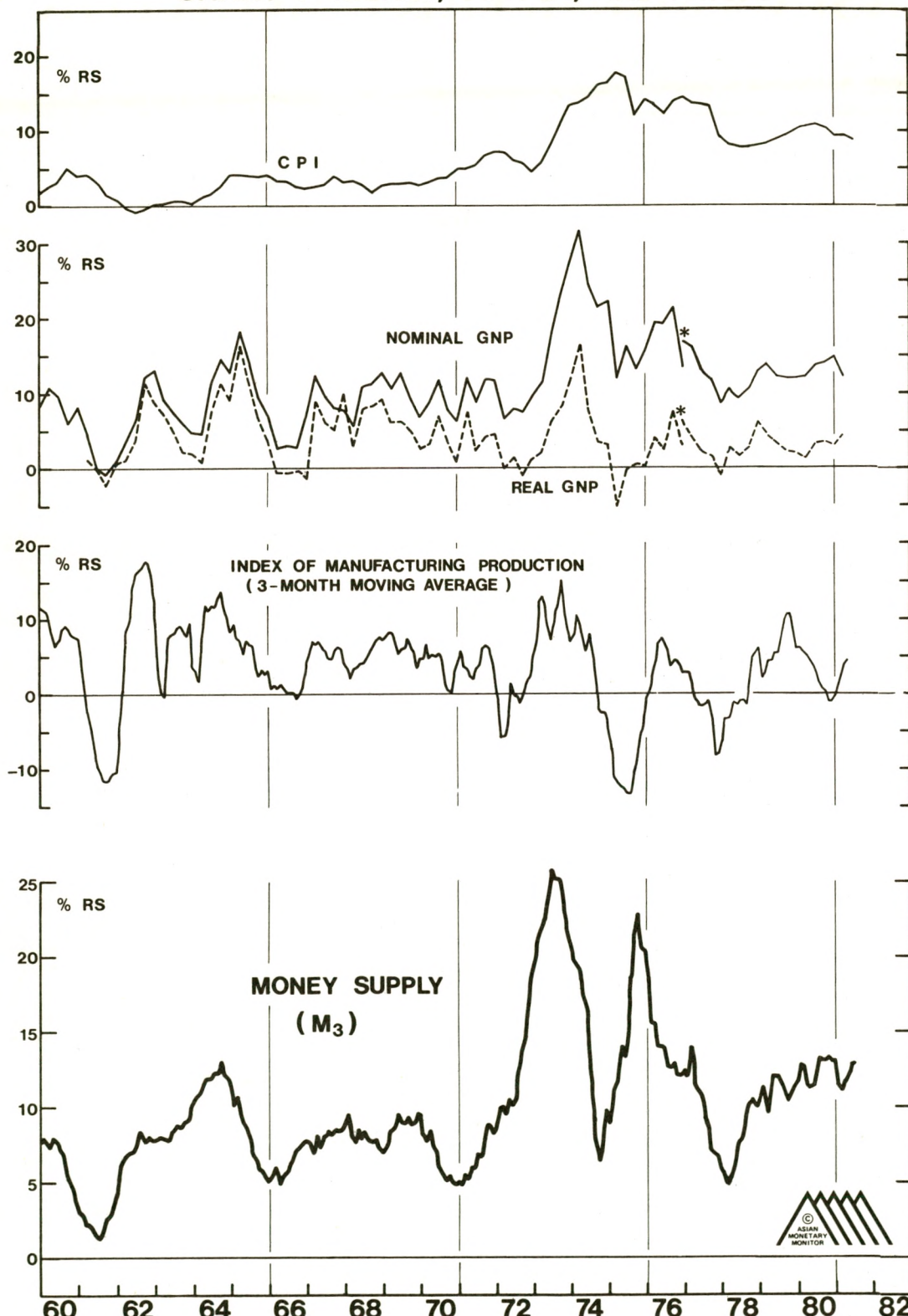
% RS - Percentage Rate of change over Same period of preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

AUSTRALIA

CHART 1 : MONEY, OUTPUT, AND PRICES



*Change of data series.

AUSTRALIA

INTEREST RATES HAVE YET TO PEAK

Domestic interest rates in Australia are at or close to record high levels for all maturities in each sector of the money and fixed interest markets. With the exception of a limited number of building society call rates, yields and interest rates in Australia have risen by a minimum of two hundred basis points over the last year. Not surprisingly, the largest increases have been recorded at the short end of the yield curve. Six month Treasury Notes were priced to yield 14.25% in July as compared with 10.73% in July 1980. Nevertheless, long term yields have also risen sharply: ten year Commonwealth debt currently yields just under 14% to redemption in comparison with 11.75% a year ago.

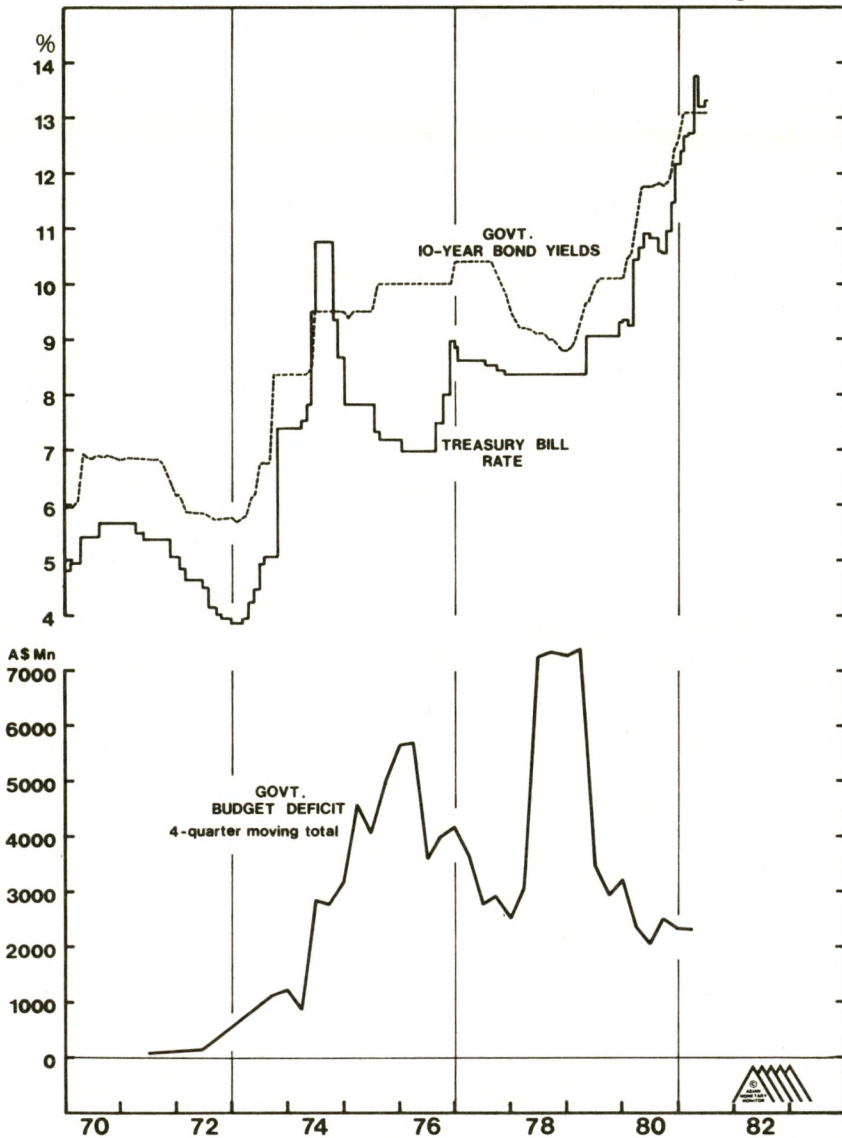
Although rising interest rates have been a typical characteristic of virtually all economies during the past year it is important to note that these increases have generally been concentrated at the longer end of the yield curve. All OECD economies now face higher long term yields than in mid-1980. The comparative performance at the shorter end of the maturity spectrum, however, has differed substantially from country to country. By and large, short rates have declined in those economies where monetary growth and inflation have eased, and whose Central Banks have not made concerted attempts to defend their currencies against a rising US dollar. Japan and the UK are good examples of this category and both countries now enjoy positively shaped yield curves in contrast to much of their experience in 1980.

Countries which have experienced rising short term interest rates fall into two broad categories. First, there are economies such as West Germany and France where the Bundesbank and the Bank of France have tried to support the Deutschmark and French Franc against the US dollar by defensive increases in short term rates. Second, countries such as the US and Switzerland have allowed short interest rates to rise whilst their Central Banks follow, or are trying to follow, independent tight monetary policies designed to reduce inflation. The yield curves in these countries have tended to become much more negatively sloped during the last year or so.

A glance at recent trends in the Australian economy, however, suggests that Australia cannot be fitted neatly into either of these broad categories outlined above. It seems to us that the rise in short interest rates is not primarily the consequence of either a severe domestic squeeze, or of Reserve Bank operations to defend the Australian dollar. Australian interest rates are rising principally as a consequence of continued high rates of inflation, rising inflationary expectations, and strong growth in the domestic economy. The Australian business cycle is not, in our view, in the final stages of a cyclical expansion and thus therefore it is likely

AUSTRALIA : CHART 2

Interest Rates and the Commonwealth Government Budget Deficit



that interest rates will rise still further from their near record levels at some stage over the next one or two years.

Before examining the basis behind these conclusions it is must be pointed out that in its recent Budget the Australian government stated it was taking specific steps to counteract the possibility of higher interest rates over the next year. The Budget was received with cautious optimism in this regard: the domestic government surplus is budgeted to rise by some A\$1.1 billion to A\$1.5 billion and the overall deficit is projected to decline to a relatively insignificant A\$146 million. It is hoped that the higher domestic surplus will mitigate upward pressure on medium and longer dated interest rates by limiting government credit demands at a time when

private loan demand is still buoyant, and by reducing the need to sell government debt to the non-bank private sector. These two factors should, it is widely asserted, enable the government to attain its new fiscal 1982 monetary target of 10%-11% growth in M3 with lower interest rates that would otherwise have been the case.

We have no particular argument with this view. A smaller government deficit almost certainly means that it can be financed at a lower level of interest rates than would otherwise have been necessary. However it is debatable whether a lower government deficit will actually change the overall direction of interest rates on a cyclical basis, unless other conditions are also in place. Chart 2 illustrates this point. There have been large variations in the Commonwealth budget deficit during the last decade but there has been little perceptible positive correlation between changes in the size of the budget deficit and the level of short or longer term interest rates.

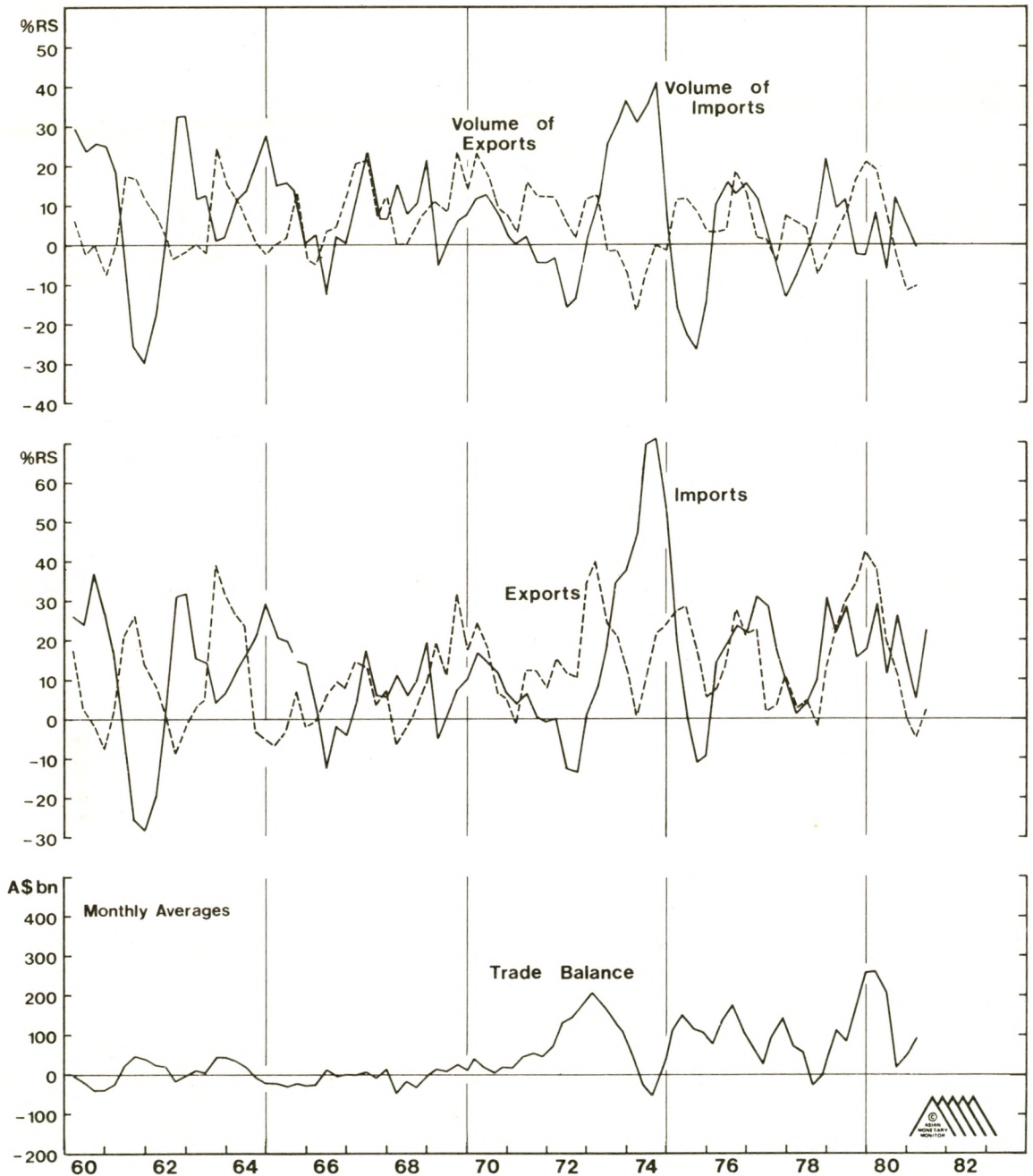
The "other conditions" that are generally a prerequisite for sustainably lower interest rates are essentially those which are characteristic of a cyclical downturn in the Australian economy. It is quite clear, however, that the domestic economy in Australia is exhibiting few, if any, of the signs typically associated with a decline in economic activity. Total unemployment, for example, edged below 350,000 for the first time since 1976. This gradual fall in overall unemployment created a steady tightening in the labour markets, and has been reflected in a cyclical upturn in the rate of increase of nominal wages. Average weekly earnings rose an average of 8% during 1979 and 1980 but have accelerated by more than 14% since the final quarter of last year. This rise in average earnings is three or four percentage points higher than the underlying level of inflation. It is therefore probably an important reason behind strength of the Australian consumer sector over the course of the last year.

Retail sales, in real terms, have grown by nearly 6% since September 1980, which marks the first significant increase in retail activity since 1977.

Other indicators of economic activity also suggest that the Australian economy has been relatively buoyant during the last year. Real G.N.P. expanded by nearly 5% in the year to March, and industrial production increased by approximately the same amount after a sluggish performance in 1980 (see Chart 1). There has been a considerable amount of discussion, by both government officials and private commentators, over the factors behind this relatively high growth rate. One factor that is often mentioned is the unusually high level of private capital investment evident during the last year and a half. The value of investment in new capital equipment expanded more than 25% (on a seasonally adjusted basis) from June 1980 to March 1981. This, it is asserted, is evidence of domestic and international confidence in the Australian economy - especially in its resource sectors.

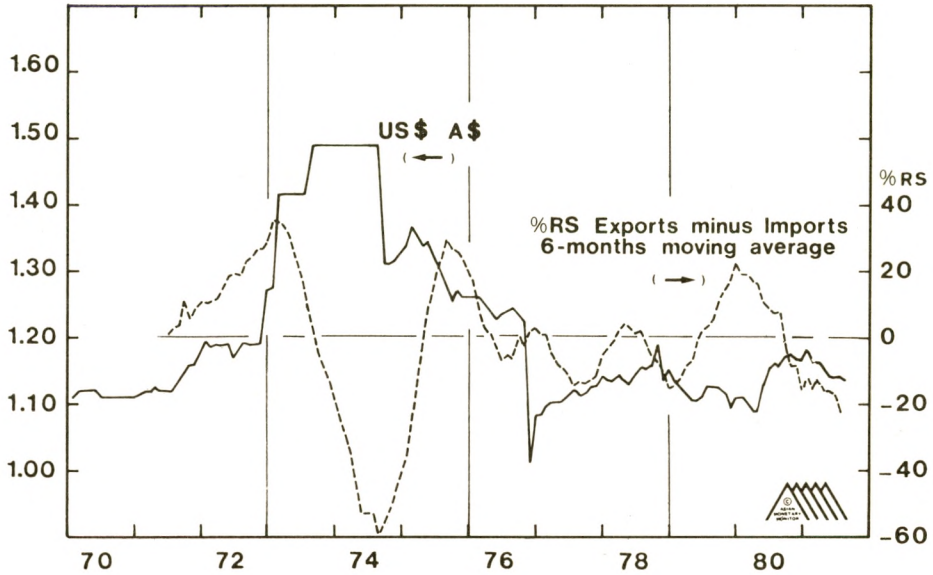
AUSTRALIA

Chart 3: The Trade Account



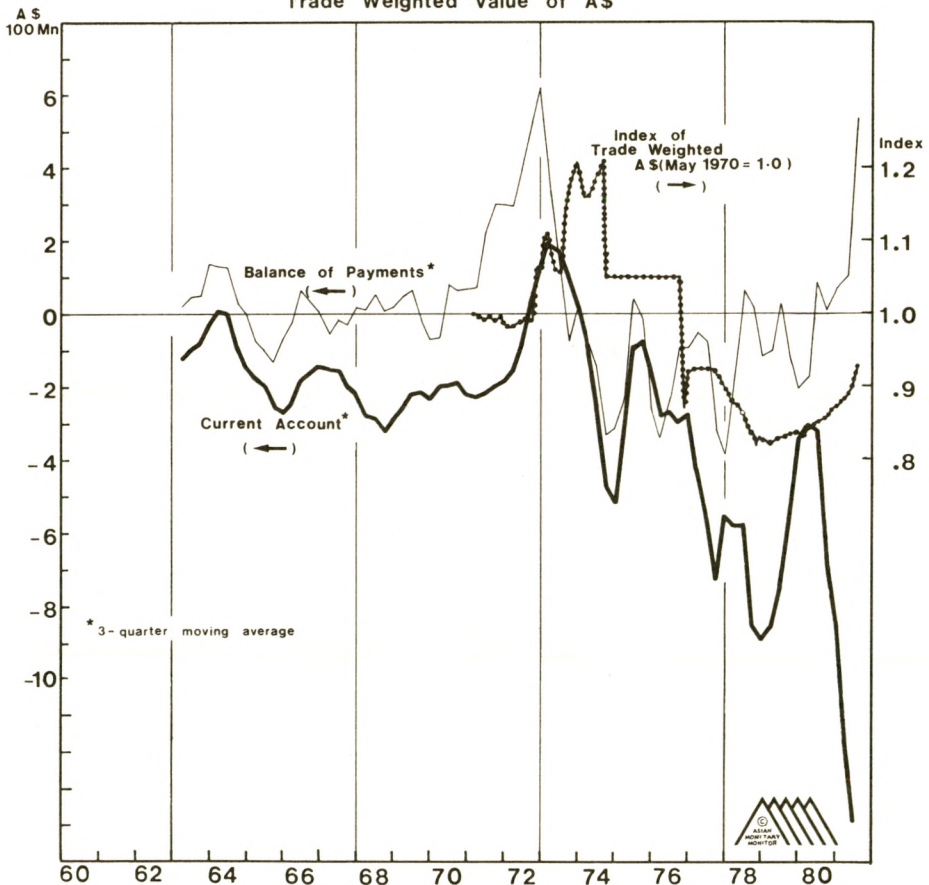
AUSTRALIA

Chart 4 : The Trend in the Australian Trade Account



AUSTRALIA: CHART 5

Current Account, Balance of Payments and Trade Weighted Value of A\$



Nevertheless, Australia's infamous "resource boom" is apt to create at least as many problems as it may appear to solve. Although large capital investment in oil and mineral exploitation projects is likely to prove profitable for the individuals and companies involved, and although such investment has contributed to high real economic growth in the shorter term, the economy as a whole is likely to suffer in the medium term.

To see why this is the case, we need first to briefly examine the counterparts of relatively high levels of economic activity in Australia's domestic economy. For whilst real wages, consumption and investment have risen quite rapidly, the external sector of the Australian economy has slumped.

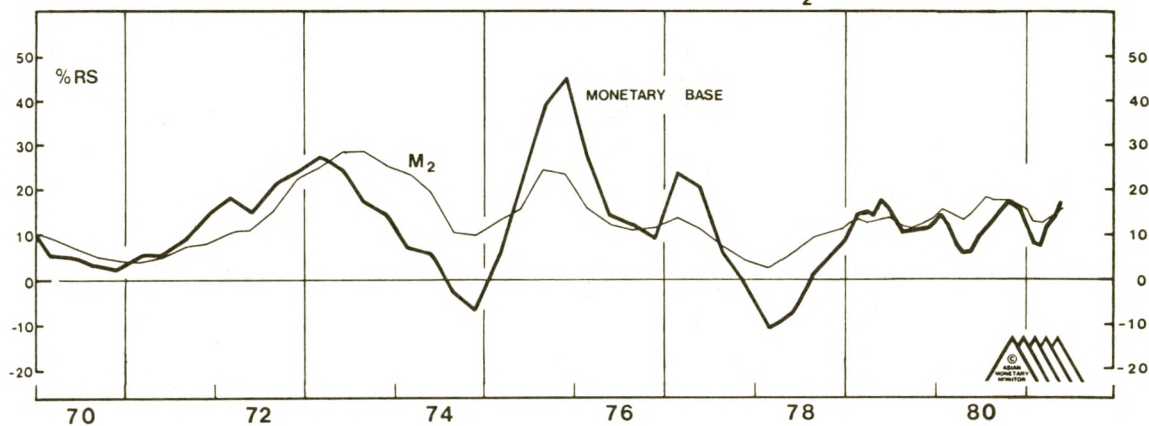
Charts 3 and 4 illustrate the swift deterioration in Australia's balance of trade since the record surpluses at the beginning of 1980. Chart 3 illustrates that the decline in the trade surplus has been faster than at any stage during the past two decades. Australia's exports have suffered particularly badly as a result of slower growth in the world economy, and rose a modest 2% from the first quarter of 1980 until March 1981. This represents a substantial decline from the 45% growth achieved during 1979. Imports on the other hand have continued to expand rapidly - rising 22% in the last twelve months. The sustained decline in Australia's basic trade position is outlined in Chart 4.

An examination of the overall balance of payments confirms the deterioration of Australia's external sector. The current account deficit has plunged even further during the last year. The Australian government foresees that the current account deficit will rise to between six and seven billion dollars. This is a 50% increase over the previous record deficits that surfaced during 1978.

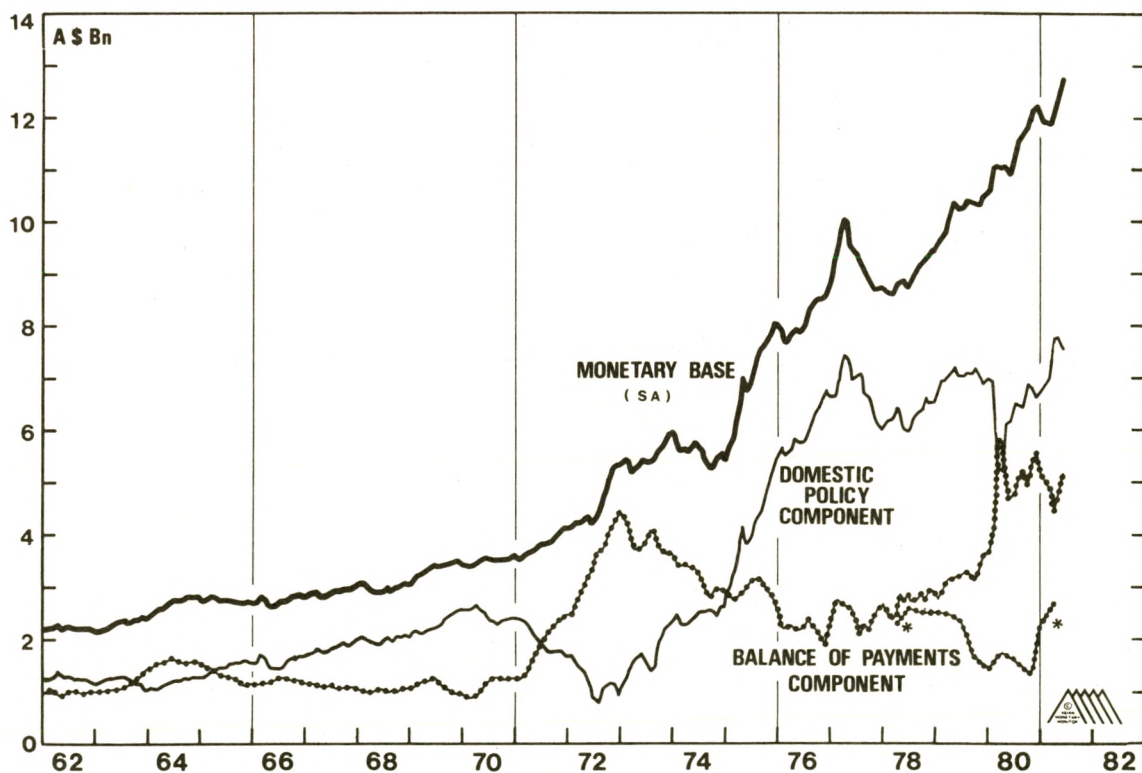
Buoyancy in the domestic sector and the weakening external sector are integrally linked. Last year, Australia had one of the highest growth rates amongst developed economies, and it was the only OECD economy to enjoy higher growth than in 1979. Australia's business cycle has thus moved out of phase with most of its major trading partners. Whilst other economies have experienced cyclical downturns, and now enjoy improving inflation and trade positions, (e.g. Japan, West Germany and Switzerland). Australia is entering its fourth year of rising real growth. Charts 4 and 5 highlight the fact that given the existing exchange rate, inflation and aggregate demand are simply too high to guarantee a turnaround in Australia's external sector over the next year.

Divergent trends between Australia and other economies have occurred previously, notably during 1974-75. During that cycle, however, the resulting balance of payments deficit created an external drain on domestic monetary growth. This process is illustrated in Charts 6 and 7. The disparity between inflation and aggregate demand trends in Australia and elsewhere led to a drain on the external, or balance of payments, source of the monetary base. This led to a fall in

AUSTRALIA : CHART 6
IMPACT OF THE MONETARY BASE ON M_2



AUSTRALIA
CHART 7 : MONETARY BASE AND COMPONENTS



*Balance of Payments component adjusted for valuation changes

the rate of growth in the monetary base and then in the wider monetary aggregates which precipitated a sharp contraction within the domestic economy. During this cycle, however, the very large current account deficit has not created a comparable overall balance of payments deficit. This is due to a sharp rise in the level of private capital inflows which the Australian Treasury estimate may be as much as A\$6 billion in fiscal 1982. Thus instead of an external drain (which would be beneficial in the longer term), there has recently been an external stimulus to Australian money growth. As a result, Australia is also virtually the only OECD economy not to have experienced a monetary slowdown during the last four years.

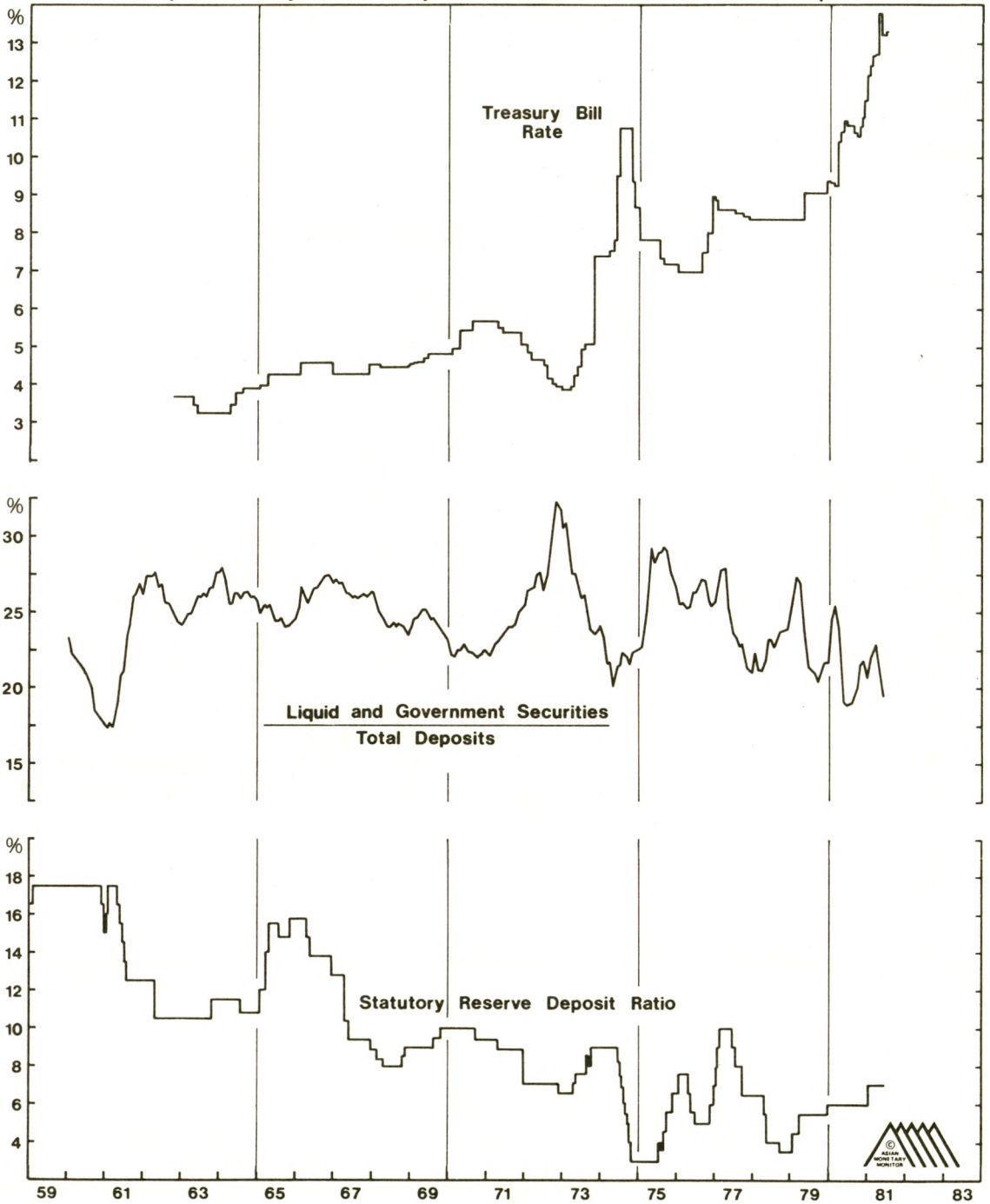
This situation is unsustainable, and is in our opinion likely to prove bearish for domestic interest rates. At some stage over the next two years Australia must face the prospect of a cyclical slowdown in monetary growth associated with a cyclical balance of payments deficit. This deficit will arise either as a consequence of a worsening current account deficit - which is the logical consequence of the divergence between levels of economic activity in Australia and its trading partners - or a fall in private capital inflows. The downturn in monetary growth will signal the final phase of Australia's current business cycle.

On the evidence of previous business cycles this phase will be associated with further rises in short interest rates. Before we examine the economic characteristics which generally surround the peak in short interest rates it is worth pointing out that "liquidity" in the Australian banking system is already tight from the banks' point of view. Chart 8 illustrates this. The Australian banks have agreed to maintain a minimum proportion of their assets (equal to 18% of their deposits) in assets which are known as LGS (Liquid assets and Government Securities (mainly Treasury Bills, Notes and cash). When the Reserve Bank decides to follow a tighter monetary policy it revises the Statutory Reserve Deposit (required banks' balances at the Reserve Bank) ratio. In order to meet the Reserve Bank's requirement for greater cash, Trading Banks generally sell a portion of their Liquidity and Government Securities. However as the LGS ratio approaches its agreed minimum, the incremental impact of a rise in the SRD ratio on local interest rates increases. For banks are probably forced not only to sell Treasury Bills etc., but to reduce the size of their loan portfolio. Chart 8 indicates that the Trading banks' LGS ratio is now close to its lowest level in several years. If the Reserve Bank does feel constrained to raise the SRD ratio in order to combat excessive monetary growth then the impact on short rates could be substantial purely on the basis of the banks' current liquidity position.

During the last two decades the economic circumstances surrounding cyclical peaks in Australian interest rates have been quite similar. In 1960-61, 1966, 1969-70 and 1973-74, a number of developments had already occurred before interest rates began sustained declines. The SRD ratio had always risen

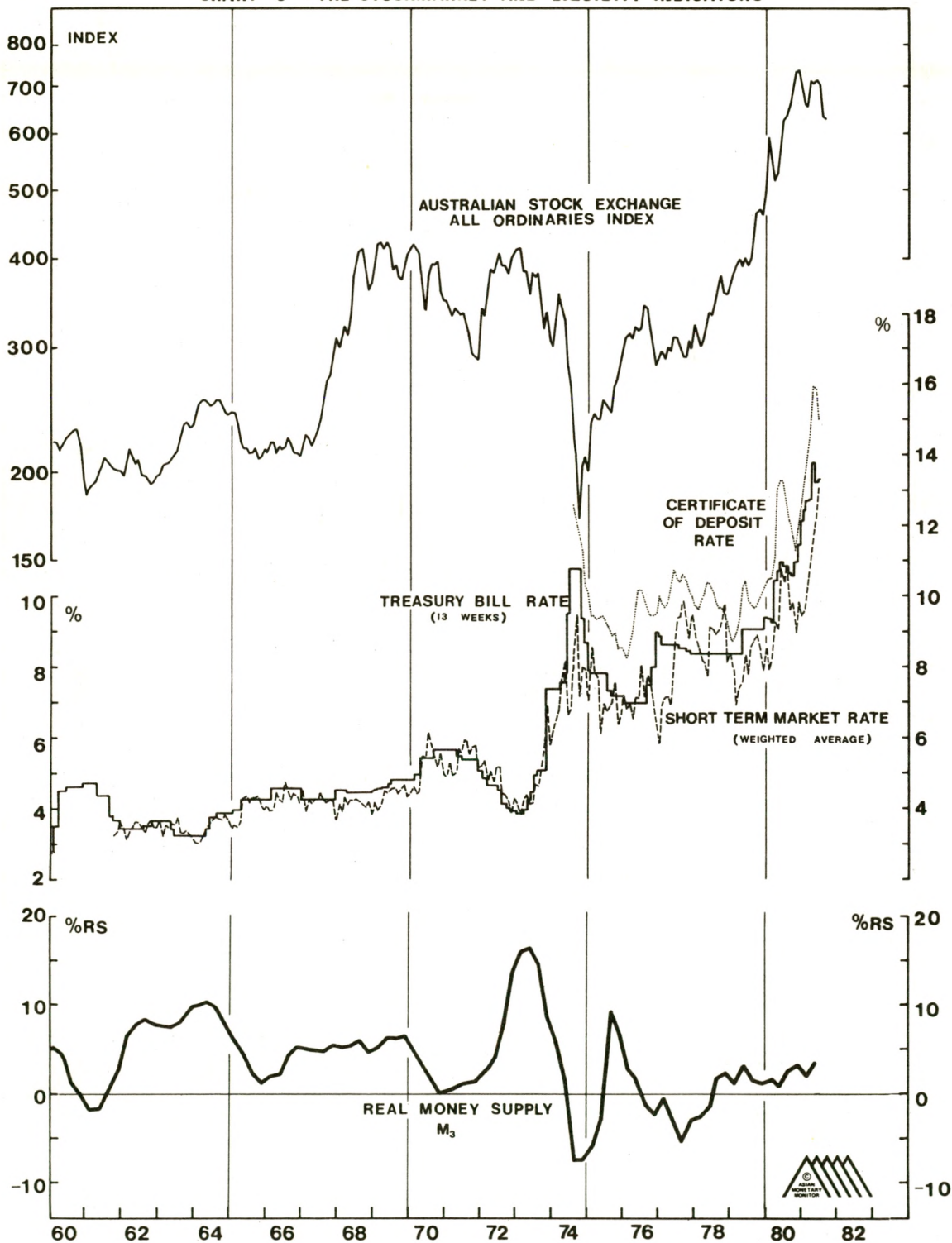
AUSTRALIA : CHART 8

Statutory Reserve Deposit Ratio, Liquid and Government Securities and Treasury Bill Rate



AUSTRALIA

CHART 9 : THE STOCKMARKET AND LIQUIDITY INDICATORS

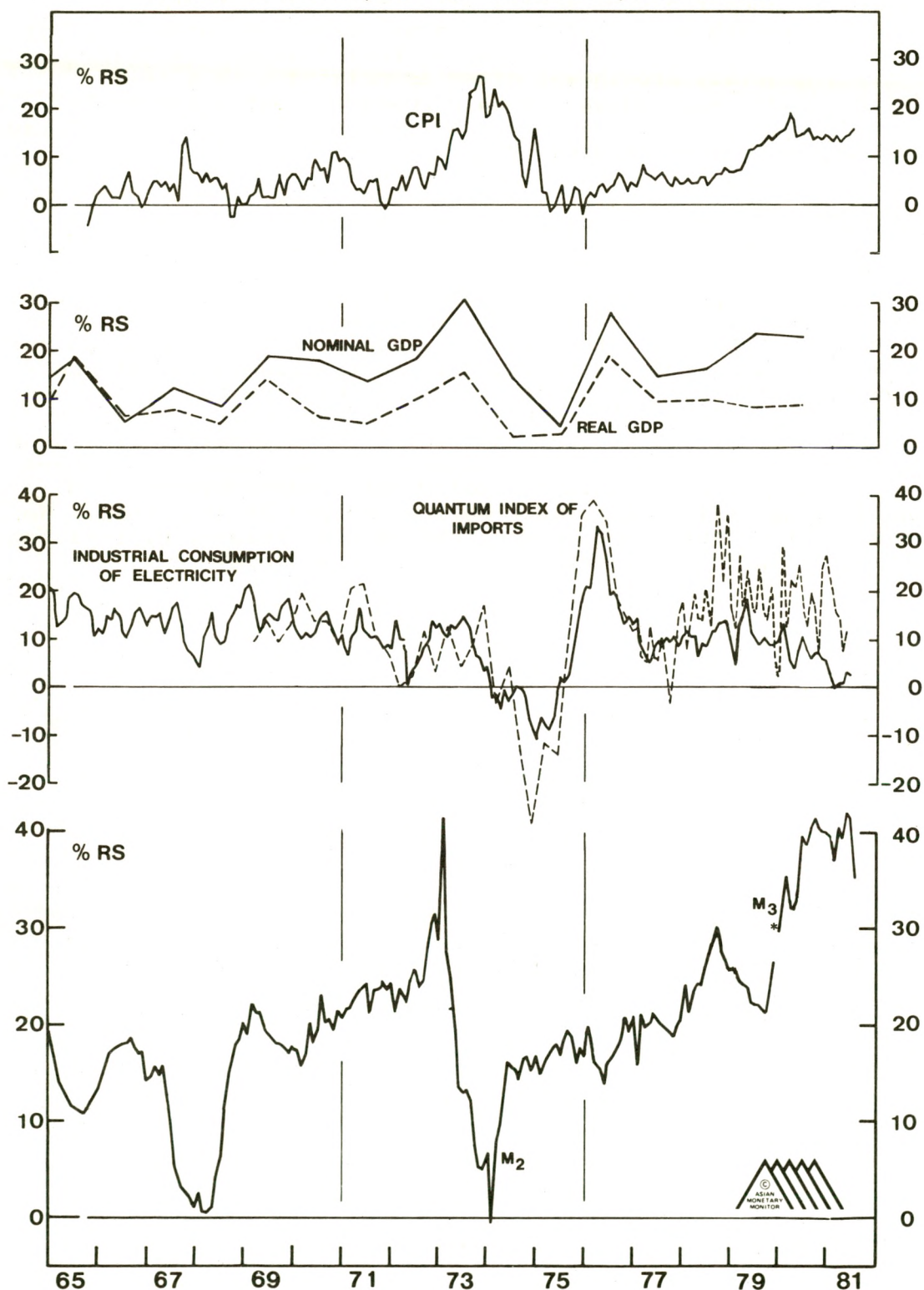


to a cyclical high, whilst the LGS ratio was usually at a cyclical low. More importantly, the peak in interest rates typically occurred some months after the cyclical high in monetary growth such that the economy was always either in, or about to enter, a period of falling real growth. Falling nominal monetary growth was often associated with a trade deficit (1966 was unusual in this respect), but a generally weaker external sector has been a further characteristic of the peak in Australian interest rates.

FORECAST: These particular economic features were common to the end of each of the last four business cycles. They are obviously very general features, but taken as a whole they indicate that the Australian economy has not reached the top of its present cyclical boom. This is bearish for interest rates because it shows that the domestic economy has failed to adjust to a changed external environment. Australian inflation and domestic aggregate demand are too high relative to its competitors. This will result in a further deterioration in Australia's current account, and this will ultimately provide a binding constraint to any continuation of the present business expansion. Thus domestic liquidity will become tighter and short rates will rise further before the end of next year. We should not be surprised to see three month Treasury Bill yields close to 18% in the fourth quarter of this fiscal year.

HONG KONG

CHART 1 : MONEY, OUTPUT INDICATORS, AND PRICES



*CHANGE OF M₂ TO M₃ SERIES

HONG KONG

TIME TO BLOW THE WHISTLE

During the recent precipitate slide of the Hong Kong dollar from around HK\$5.40 per US\$ towards HK\$6.00, there were several occasions on which it was reliably reported that the Hong Kong government had intervened to support the local currency on the foreign exchange market.

Such intervention, when carried out by a central bank in an orthodox banking system, can be effective in supporting the local currency. But in the case of Hong Kong's peculiar and unorthodox banking structure such intervention is utterly pointless and futile.

To understand why this is so it is necessary to see (a) how a normal central bank and banking system operates and how intervention in the foreign exchange market can be made effective, (b) how Hong Kong's automatic adjustment mechanism under a fixed exchange rate operated in effect like any orthodox central bank would have done, (c) how errors of policy caused Hong Kong's banking system to come off the rails in 1972-74, and how the system now differs from orthodox banking systems around the world and hence (d) why operations in the foreign exchange market by the government or Exchange Fund under present institutional arrangements neither tighten the money market nor reduce monetary growth.

(a) Intervention in an orthodox banking system

When a central bank in a normal banking system faces a balance of payments deficit and wishes to support the local currency, it will sell foreign currency. To do this it simply calls up any foreign exchange dealer and places an order to sell foreign currency. Assuming the dealer can find a willing purchaser, the central bank's foreign exchange holdings will be reduced. At the same time the buyer (or dealer) must pay the central bank an equivalent amount in domestic currency for the foreign exchange, so will write a cheque drawn on his bank, payable to the central bank. When the central bank receives this cheque it does not redeposit it in the banking system, but merely debits the account of the paying bank at the central bank.

If we assume the central bank records no other subsequent transaction, the net effect is to reduce the reserves of the commercial bank in question (i.e. its deposits at the central bank), and thus of the commercial banks as a whole. With less reserves the banks must now reduce their loans if they are to maintain their previous deposit/reserve ratio. But as they reduce their loans, so their deposits will decrease. This adjustment process will continue until a new equilibrium is reached where the new level of bank reserves (set by the central bank via its original sale of foreign exchange) is compatible with the banks' desired or required deposit-to-

reserve ratio, and until the public has adjusted its level of cash currency holdings to the new deposit level. The crucial point is that at the end of the whole process, the money supply would have declined by some multiple of the original amount of domestic currency purchased by the central bank.

The original intervention in the foreign exchange markets "supported" the currency in the sense that the central bank came into the market as a buyer of domestic currency, but the more important effect was that intervention produced a multiple contraction in the banking system. This tightening of the money supply would raise interest rates in the first instance, slow down domestic expenditures, and in time produce a correction in the balance of payments both through induced capital inflows and through reducing the demand for imports as the growth of domestic spending declined. All these effects would tend to strengthen the currency, which was what the original intervention was intended to achieve.

However, in the case of Hong Kong today almost none of these effects occur. And this is not because Hong Kong does not have a central bank. For the period of fixed exchange rates, the mechanism as described here did operate in Hong Kong. To see that, however, one must make one or two small qualifications because the system described above is not immediately recognisable as the system which used to operate in Hong Kong, although in principle the mechanism was identical.

(b) Hong Kong's automatic adjustment mechanism during the era of fixed exchange rates

With just two small modifications the mechanism described above for an orthodox central bank system also explains the operation of the classical adjustment process system in Hong Kong.

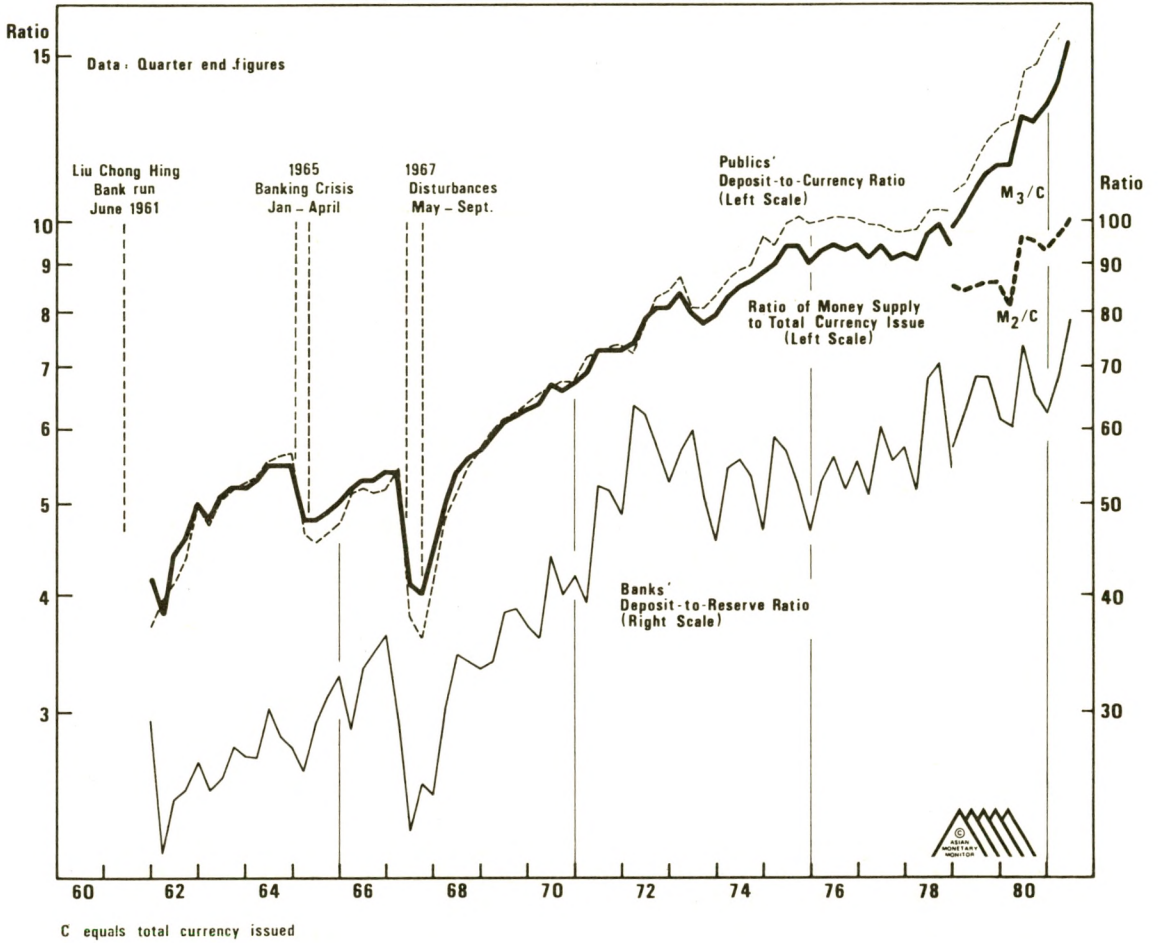
First, instead of Hong Kong's commercial banks holding reserve deposits at the "central bank" or Exchange Fund, they only held Certificates of Indebtedness, or authorisations to print bank notes. In effect bank notes - or their counterparts, the CIs - were the only "reserves" in the system.

Second, the Exchange Fund's only assets used to be foreign exchange whereas the orthodox central bank we were describing in the preceding section might have held a variety of other assets denominated in domestic currency. As long as the Exchange Fund only held foreign currency assets and the sole counterpart to these was CIs, i.e. the notes held by the banks and public (rather than deposits of banks), it could not deliberately alter the quantity of reserves in the system of its own accord.

As a consequence, the supply of reserves or notes was a passive process resulting partly from the balance of payments, partly from the public's demand for currency, and partly from changes in the amount of notes the banks wanted to hold in their tills as vault cash. Reserves were not actively or deliberately determined by the Exchange Fund; what the Exchange

HONG KONG

CHART 2: MONETARY DETERMINANT RATIOS



Fund did was to fix the "price" of those reserves, i.e. the value of the HK\$ in terms of other currencies. As a corollary, the money supply in Hong Kong was not 'deliberately determined'. The quantity of money at any point in time reflected (1) the interacting decisions of the banks and public about the relative amounts of deposits or currency they wished to hold, and (2) the state of the balance of payments given the particular exchange rate chosen by the Exchange Fund.

In our example of the operation of an orthodox banking system it was a balance of payments deficit which triggered off the intervention to support the currency and resulted ultimately in a multiple contraction of the assets and liabilities of the banking system. In the classical automatic adjustment mechanism operating in Hong Kong reserves were also depleted by a balance of payments deficit, but this was more the outcome of the process than the trigger to the adjustment. The balance of payments adjustment or change in the money supply occurred primarily through the impact of private portfolio decisions. If the demand for imports or overseas assets increased, the banks' foreign assets would be depleted leaving them less foreign currency with which to buy CIs (to print notes). This would mean that to meet increased demand for banknotes the banks faced a choice:

either they must reduce their loans and sell HK\$ to acquire the necessary foreign currency to purchase the CIs,

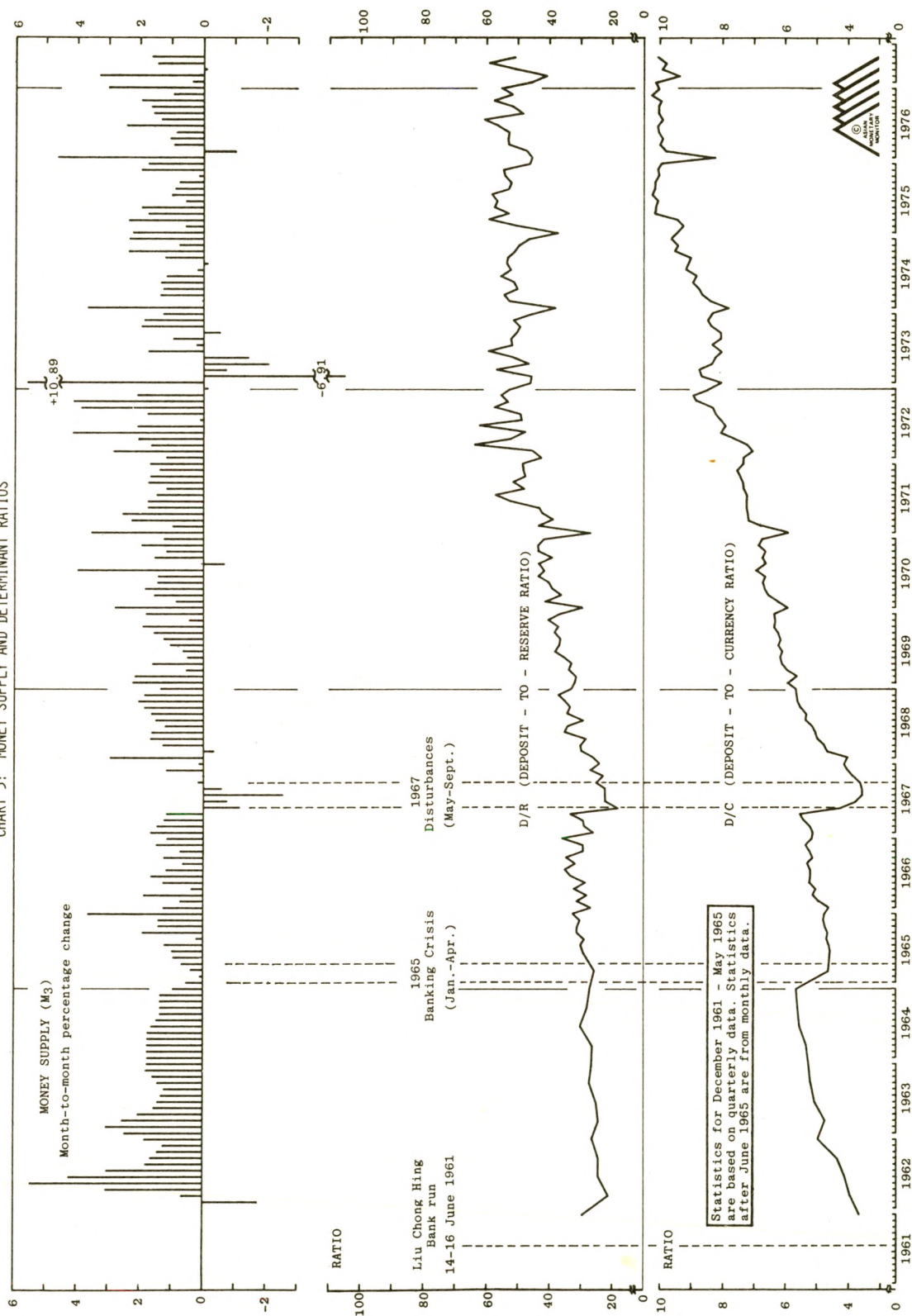
or they must reduce the amount of cash they held in their tills (vault cash) relative to deposits.

The first course of action would reduce the amount of deposits, and in time reduce spending, ultimately leading to a lower demand for banknotes. The second, which would involve cancelling CIs in exchange for foreign currency, would run the risk of banks being caught short of banknotes with which to meet customers' needs, and would probably only ever be undertaken temporarily. In short, a sustained shift towards balance of payments deficit (due to an increase in demand for imports or net capital outflows) would ultimately force the banks to call in their loans, and this would have a contractionary effect on the money supply.

Over long periods of time variations in the banks' deposit-to-reserve ratio were not important. In other words most of the growth in the money supply occurred through conversions of foreign currency remittances (i.e. via the balance of payments), but from time to time changes in this ratio have been significant, for example the period 1971-72 (see Chart 3).

Similarly there have been long periods when the public's demand for currency relative to deposits has not altered much, but from time to time large scale conversions of deposits into currency have been crucial determinants of the overall quantity of money, as for example during the banking crises of 1961 and 1965, and during the 1967 disturbances (see Charts 2, 3 and 4).

HONG KONG
CHART 3: MONEY SUPPLY AND DETERMINANT RATIOS



To summarise, the level of reserves under the old Hong Kong system was the simultaneous outcome of the balance of payments and the money supply, with the money supply also being affected by the portfolio decisions of the banks and the public concerning their respective deposit-to-currency ratios. In normal times changes in reserves and the overall balance of payments would have been well correlated together, but variations in the banks' and the public's deposit-to-currency ratios would have served at times to cushion and at other times to amplify the direct impact of the balance of payments on the money supply. In a statistical sense therefore changes in the balance of payments or reserves were the dominant influence on the money supply in the longer term.

The essential difference between the orthodox central bank in our previous example and the Exchange Fund in the latter is that changes in the reserves in the orthodox central bank system were deliberately engineered, while changes in the Exchange Fund system occurred passively. In the first case deliberate intervention to maintain a particular foreign exchange rate (with no offsetting action) produced a multiple contraction. In the Hong Kong case a balance of payments deficit also used to produce a multiple contraction, but the contraction occurred as a by-product of decisions by the private sector, and the Exchange Fund remained essentially passive. In both cases any variations in the deposit-to-reserve ratio of the banks or the deposit-to-currency ratio of the public would amplify or modify the direct link between the balance of payments and the money supply and, though critical from time to time, shifts in these ratios were relatively rare so their importance was limited to those occasions when public behaviour did alter (as in the 1965 bank runs, or the 1967 disturbances).

However, the essential similarity of the two mechanisms was that the effects of slower monetary growth in Hong Kong on the local currency would have been exactly analogous to the effects of slower monetary growth under the orthodox system: higher interest rates, slower growth of expenditures and ultimately a correction in the balance of payments. So although the initial decisions which produced the change in reserves were different in each case, the end results of the process for the economy were identical. Thus, for example, just as the fixed exchange rate and explicit intervention by the Bank of Japan operated so as to keep prices in Japan in line with the prices in the USA throughout the period 1949-1971, so a fixed rate in Hong Kong without explicit intervention but with the Exchange Fund passively supplying currency kept prices in Hong Kong in line with prices elsewhere.* The fact that Japan had a central bank and Hong Kong did not is, as we have shown, a difference of form, not of substance. The adjustment mechanism in both economies worked so that at the end of the day the two economies "adjusted" to external circumstances (the fixed

* See AMM Vol. 3 No. 3 May-June 1979 for a demonstration of this proposition for Japan, and AMM Vol. 3 No. 4 July-August 1979 for a demonstration of this proposition for Hong Kong.

exchange rate and the inflation rate overseas), inflating when countries to whose currencies they were pegged inflated, and deflating when they deflated.

(c) How Hong Kong's Monetary System Went off the Rails, 1972-74

During the late 1960s and early 1970s Hong Kong's authorities had to deal with many external difficulties. Among the most important and worrying of these was the devaluation of sterling in 1967, and the subsequent protracted negotiations in the early 1970s about how to diversify Hong Kong's reserves without putting undue strain on sterling itself.

From the standpoint of Hong Kong's domestic monetary system two types of changes were introduced. First there were outward and visible changes, and second there were the technical, internal accounting changes, not very much publicised at the time but nonetheless highly significant in terms of their impact on the operation of the classical adjustment mechanism.

Starting in June 1972 the external value of the HK\$ was unpegged from sterling and pegged to the US\$. In other words the Exchange Fund no longer issued CIs at a price quoted in sterling, but quoted a price in US\$. At the same time and following discussions with officials from the IMF and elsewhere, the authorities introduced a band within which the price of the HK\$ per US dollar could move. Aside from introducing more variability into the relationship between the balance of payments and the money supply these moves were unfortunate because the US\$ itself was losing credibility as a stable store of value as American inflation accelerated. Also, with the American economy experiencing a strong monetary expansion at home, all those Asian economies with currencies pegged to the US dollar began to experience massive balance of payments surpluses which explicit central bank intervention naturally translated into huge monetary expansions. Hong Kong was no exception (the only difference being that the Exchange Fund was a passive participant in the process), and in 1971-72 monetary growth exploded, with M2 going from 22% year-to-year growth at the start of 1972 to 41% in January 1973.

As the effects of this monetary explosion became evident in a soaring stock market, a booming real estate market and accelerating consumer price inflation, the balance of payments switched from surplus to deficit putting the whole process into reverse. The money supply turned down (recording absolute declines in each of the months from February to May 1973, for a total decline of 10.8% in four months), the stock market crashed, and property values plunged.

As if the gyrations on the domestic money markets and stock markets were not enough for the Hong Kong government to cope with, the gradual move towards floating exchange rates in the international economy from August 1971 onwards combined with the impact of the 1973-74 oil crisis, plus the switch from generally expansionary monetary policies to tight monetary

policies around the world meant that the US dollar was fluctuating quite widely on foreign exchange markets against many other currencies. If the Hong Kong dollar was pegged to the US dollar but floating against all other currencies, then why not allow it to float against the US\$ also?

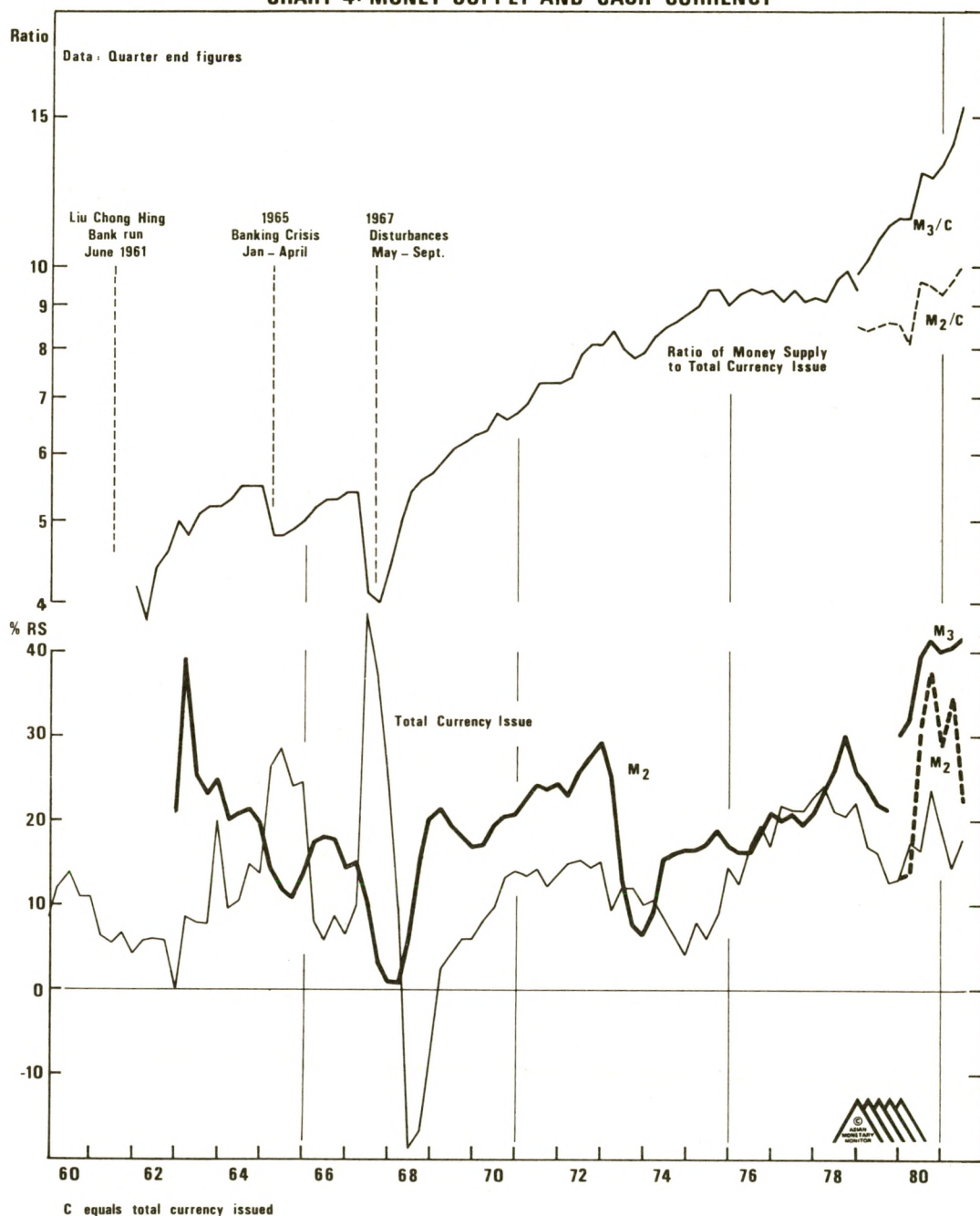
The logic of this view seemed to be confirmed by the futility and frustration which the Hong Kong authorities were newly experiencing as they tried actively for the first time to peg the currency within the band. The new tools for intervention came from some technical and internal measures not publicised very much at the time, but which changed the structure of the Hong Kong banking system in a basic and fundamental way. For, having given an undertaking to maintain the Hong Kong dollar within a band vis-a-vis the US dollar, it was soon realised that the Exchange Fund had no Hong Kong dollars which it might be able to sell if the market rate threatened to move up against the upper limit of the band. To give them the necessary ammunition the authorities did three things:

- (1) they set up deposit accounts** in Hong Kong dollars for the Exchange Fund with the two main note-issuing banks;
- (2) they borrowed Hong Kong dollars from the commercial banks to provide a temporary cushion which they could use in emergency; and
- (3) to repay their borrowings and to ensure they would have a source of HK\$ in the future the authorities asked the note-issuing banks to pay for Certificates of Indebtedness not in foreign currency but in HK\$ by crediting the new HK\$ deposit accounts of the Exchange Fund at the banks.
(Presumably the authorities felt they could do this because having earned a handsome yield for many years on their foreign exchange, the assets of the Exchange Fund were now well in excess of the minimum 105% cover required to guarantee the note issue.)

On the surface these measures appeared to enable the Exchange Fund to intervene in the foreign exchange market to shore up (or hold down) the HK\$ because now the authorities had the necessary resources in both foreign and domestic currency to intervene on either side of the exchange rate. However, and to the acute discomfort of the officials concerned, they soon discovered that any intervention which they undertook was embarrassingly ineffective and did not seem to achieve any results. On occasion huge quantities of reserves were fruitlessly used up in the vain attempt to hold the Hong Kong dollar to some elusive and arbitrary parity band. Accordingly the authorities finally abandoned the struggle and in November 1974 the HK\$ was allowed to float.

To summarise, the machinery for the "passive" expansion and contraction of money had been left intact, but the central pivot on which the old adjustment mechanism had depended - namely the fixed external value of the currency - was abolished since the currency was allowed to float. Worse still, tacked on to the old structure were the Exchange Fund's new accounts

HONG KONG
CHART 4: MONEY SUPPLY AND CASH CURRENCY



** These may not have been entirely new: the Exchange Fund may have kept small HK\$ deposits before to meet petty expenses, but the practice of accepting and depositing HK\$ funds against CIs must have raised the size of transactions on such accounts to an entirely different level of magnitude, at the same time as transforming the monetary implications of issuing CIs.

CENTRAL BANK OR NO CENTRAL BANK ? A CRITIQUE OF THE OFFICIAL CASE

The official case against establishing a central bank in Hong Kong was formally set out by P.W. Allsopp, Deputy Secretary for Monetary Affairs in a speech on Tuesday 27th November, 1980. His procedure was to define a central bank in terms of its functions, listing 12 typical functions (in no particular order of priority):

- (a) acting as financial adviser to the Government;
- (b) supervising the private deposit-taking sector (including the banks);
- (c) regulating the exchange rate;
- (d) managing the economy's foreign currency reserves;
- (e) acting as banker to the Government;
- (f) issuing notes and coins;
- (g) managing the Government's debt;
- (h) carrying out open market operations;
- (i) acting as lender of last resort to the money market;
- (j) acting as banker to the banking system;
- (k) organising emergency support for banks and other deposit-taking institutions; and
- (l) operating or supervising exchange control.

He then asked the question, which of these functions is already carried out by the monetary authorities in Hong Kong? In answer to this he proceeded to demonstrate that almost every function was currently being performed by the Exchange Fund itself (or by the Monetary Affairs Branch of the Government Secretariat, or by the Commissioner of Banking and Deposit-Taking Companies).

In respect of items (a) to (f) the implicit conclusion was that since the Hong Kong authorities already perform all of these tasks, a new central bank as such was not necessary. The Hong Kong and Shanghai Banking Corporation acted as lender of last resort to any particular bank in the money market (i), but the foreign exchange market was the "residual source of liquidity" for the banking system as a whole (j). The Commissioner of Banking has powers to intervene in the running of a bank that gets into solvency difficulties (k), and the Monetary Affairs Branch would be likely to take a lead in making the ad hoc arrangements for an emergency support operation.

In regard to (l), there is no foreign exchange control in Hong Kong so this can be left on one side. That leaves two functions not so far covered: items (g) and (h).

In respect of managing the government's debt (g), which is really the counterpart of managing the foreign currency reserves, there is no such debt to be managed so the issue doesn't arise.

With respect to carrying out open market operations, Allsopp correctly points out that while other governments can use open market operations to immobilise "the banking system's unlent resources", the Hong Kong government cannot because there isn't any such debt. Even if the Exchange Fund instructed the licensed banks to place Special Deposits (required reserves in American terminology) with it, he argued, in Hong Kong's circumstances the funds thus acquired by the Exchange Fund would not be immobilised but would have to be channelled back into the banking system.

"It is not the absence of a central bank which would make these circular movements of funds", he concluded, "but the absence of government debt".

Wrong.

Even if H.K. Government debt instruments existed, the movement of funds would still be circular. The reason is precisely analogous to the explanation of why intervention in the foreign exchange market does not work in Hong Kong.

In effect Allsopp's methodology was to ask what were the similarities between the functions of an orthodox central bank and the functions currently performed by the Hong Kong authorities. Instead it would have been more fruitful to have started with the question, what is it that is different about the operations of the Exchange Fund as compared with orthodox central banks?

As explained in the accompanying text the crucial differences between the Hong Kong system and other monetary systems do not so much concern the functions of a monetary authority as the accounting relationships between the authority and the banks, and the consequences which these imply for the banking system as a whole. Specifically:

- (1) Instead of the commercial banks or licensed banks holding HK\$ deposits with the monetary authorities, the Hong Kong monetary authorities hold domestic currency deposits with the commercial banks - the exact opposite to orthodox systems.
- (2) This undermines the multiple expansion or multiple contraction mechanism which is fundamental to the operation of an orthodox central bank system or, for that matter, the traditional colonial currency board system of which Hong Kong's Exchange Fund is a variant.*
- (3) It also effectively relegates the Exchange Fund from the status of an institution which can directly or indirectly control monetary growth to an institution which is on a par with any other large corporation holding deposits in the banking system.

This is what Allsopp refers to as the circular movement of funds consequent upon any operations by the Exchange Fund, and it is this which constitutes the basis for the official policy that it is not feasible to manage the foreign exchange rate or control the money supply.

Correct - insofar as it goes.

But the official conclusion that there is no operational case for the creation of a central bank in Hong Kong is, in our submission, not the end of the story. It is true that so long as Hong Kong has, in Allsopp's phrase, these "rather idiosyncratic institutional arrangements" (whereby the Exchange Fund holds HK\$ deposits with the banking system), the Monetary Affairs Branch or the Exchange Fund is prevented from acting effectively like any orthodox monetary authority to expand or contract the money supply.

However, that begs the whole question of whether these "idiosyncratic institutional arrangements" can, in the light of the events of the recent past, be considered any longer desirable for the long term health of the economy.

In our view these arrangements have not served Hong Kong well, and it is time to review them.

* Multiple expansion or contraction does still occur in Hong Kong through variations in the monetary determinant ratios (shown in Charts 2 and 3), and through the impact of the balance of payments. However the Exchange Fund no longer has the key role in this process whereas it used to have the (passive) role of setting the foreign currency price for the HK\$, which in turn determined the balance of payments.

in HK\$ at the licensed banks, together with the new practice of issuing CIs (permits to issue banknotes) in exchange for HK\$ credit. The net result to put it crudely, was a free float and a free currency issue.

Since 1974 some minor changes have been made to patch up the system as it stands, but the key elements of the new edifice, namely the Exchange Fund's accounts in HK\$ with the licensed banks, the practice of accepting HK\$ assets as payments for CIs, and the free float, have all remained intact. Moreover, the money supply has continued to grow rapidly, giving the lie to any supposed control the authorities claim to have over it through interest rates, moral suasion, or any other weapon. Many people are increasingly concerned that there is something seriously wrong with Hong Kong's monetary system, but few can specify exactly what it is, or what needs to be done.

(d) Why Intervention in the Hong Kong's Foreign Exchange Market doesn't Work

Under the orthodox central banking system described in section (a) intervention in the foreign exchange market was successful because the central bank's transactions produced a reduction in the quantity of bank reserves, and hence tightened the money supply. In the classical pre-1972 system in Hong Kong a similar result was achieved even though the Exchange Fund was a passive participant in the process. In both systems the formal pegging of the exchange rate worked because balance of payments surpluses or deficits at any given exchange rate produced a corresponding multiple expansion or multiple contraction of bank credit or deposits which in turn induced adjustments in the economy that tended to correct the original source of the problem. This self-correcting mechanism in Hong Kong was 'automatic' in the sense that the Exchange Fund was a passive participant in the process in contrast to the orthodox central bank case where the intervention was explicit and discretionary.

However, the new Hong Kong dollar accounts of the Exchange Fund with the licensed banks (actually with the two largest note-issuing banks), activated and enlarged in 1972-74 to meet the need to intervene actively in the foreign exchange market, do not have comparable multiple expansion or multiple contractionary effects (see box pp.28-29).

If the authorities wish to stop the Hong Kong currency depreciating, the Exchange Fund will buy Hong Kong dollars in the foreign exchange market from private sector owners of those deposits who will receive foreign currency deposits in exchange. The problem is that the Exchange Fund nowadays deposits the Hong Kong dollars it receives from such support operations back in the banking system, where the funds are again lent out, so there is no material change in the size of banks' balance sheets - only a transfer in the ownership of HK\$ deposits from the private sector to the Exchange Fund.

Similarly, if the authorities were in the enviable position of wishing to limit an upward appreciation of the HK\$ exchange rate, they would be equally powerless to do anything about it. The Exchange Fund would buy foreign currency from private individuals or corporations in the market and sell Hong Kong dollars to them. Insofar as the Exchange Fund is a seller of Hong Kong currency this would keep the currency down momentarily, but as soon as the authorities had no more Hong Kong dollars to sell the effectiveness of their intervention would be at an end. The net effect would be a transfer of deposits between the Exchange Fund and the private sector, but with no multiple expansion of the banking system as a whole. So the old adjustment mechanism, whereby the money supply expanded until the balance of payments was corrected by increased spending on imports or capital outflows (both induced by the monetary expansion), no longer operates.

In other words deposits 'withdrawn' from the banking system by Exchange Fund are not withdrawn at all, they are merely redeposited with the banking system. Conversely deposits 'injected' into the system by Exchange Fund intervention to keep the HK\$ rate down are not really new additions to the system at all, they are merely transfers of deposits from the government sector to the private sector with no effect on the overall size of licensed bank balance sheets.

A useful way of looking at the situation today is to regard the Exchange Fund as if it were just any large corporation. (The Exchange Fund happens to have the special privilege of enjoying the seignorage from the issues of CIs, but that is not material to the argument here.) If the Exchange Fund buys or sells foreign exchange through the banking system its transactions are just like those of any other large corporation. If the Exchange Fund Corporation buys Hong Kong dollars and the ABCD Corporation sells Hong Kong dollars the end result is a transfer of the ownership of deposits, not a change in the total quantity of deposits. This is quite a different result from the intervention operations of the orthodox central bank described in section (a) where sales and purchases of foreign currency for domestic currency led respectively to a multiple contraction or expansion in the total money supply.

The only other peculiarity of the Exchange Fund in comparison with other public corporations is that under legislation introduced in 1979 the Exchange Fund can arrange to have its Hong Kong dollar deposits treated either as deposits of a bank (in which case they must be 100% covered by so-called liquid assets), or it can have them treated as deposits of a normal corporation or individual (in which case they are subject to the standard 25% liquid asset ratio). Official assertions to the contrary notwithstanding, this facility has no monetary significance whatsoever. Switching deposits from one category to the other may affect the distribution of bank credit (i.e. the form of bank assets), but it has no effect on private sector holdings of deposits or the money supply properly conceived. (There may be a small statistical effect, but that is because the 'money supply' in Hong Kong is

THE MULTIPLE CONTRACTION PROCESS IN AN ORTHODOX BANKING SYSTEM **- HOW INTERVENTION WORKS**

STAGE 1: STARTING POINT

Central Bank	
Foreign Exchange	600
Banknotes Deposits of banks	550 50

Commercial Banks

Banknotes Deposits at Central Bank	50 50
Loans and Investments	4900
Deposits	5000

STAGE 2: INTERVENTION

Central Bank	
Foreign Exchange	590
Banknotes Deposits of banks	550 40

Commercial Banks

Banknotes Deposits at Central Bank	50 40
Loans and Investments	4900
Deposits	4990

STAGE 3: EQUILIBRIUM RESTORED

(figures have been rounded)

Central Bank	
Foreign Exchange	590
Banknotes Deposits of Banks	541 49

Commercial Banks

Banknotes Deposits at Central Bank	49 49
Loans and Investments	4818
Deposits	4916

Non Bank Public

Banknotes Deposits	500 5000
Money Supply:	5500

Banks' Deposit/Reserve ratio*: 50
 Non bank public's D/C ratio*: 10

(EQUILIBRIUM)

* These are assumed to be the desired ratios in each case.

Non Bank Public

Banknotes Deposits	500 4990
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Banks' Deposit/Reserve ratio: 55
 Non bank public's D/C ratio : 9.98

(DISEQUILIBRIUM)

Non Bank Public

Banknotes Deposits	492 4916
Money Supply:	5408

Banks' Deposit/Reserve ratio: 50
 Non bank public's D/C ratio : 10
 (EQUILIBRIUM)

Original intervention: -10
 Monetary contraction : 5408-5500=-92

THE SYSTEM IN HONG KONG - WHY INTERVENTION DOESN'T WORK

STAGE 1: STARTING POINT

Exchange Fund	
Foreign Exchange 600	Certificates of Indebtedness (CIs) 600

Commercial Banks

CIs 600	Banknote issue 600
Till cash 100	Deposits 5000
Loans and Investments 4900	

Non Bank Public

Banknotes 500	
Deposits 5000	
Money Supply : 5500	

Banks' Deposit/Reserve ratio*: 50
 Non bank public's D/C ratio*: 10
 (EQUILIBRIUM)

STAGE 2: INTERVENTION

Exchange Fund	
Foreign Exchange 590	CIs 600
HK\$ Deposits 10	

Commercial Banks

CIs 600	Banknote issue 600
Till cash 100	Deposits of non bank public 4990
Loans and Investments 4900	Deposits of Exchange Fund 10
Foreign assets 10	Foreign currency deposits of non bank public 10

Non Bank Public

Banknotes 500	
Deposits 4990	
Money Supply : 5490	
Foreign currency deposits 10	

Banks' Deposit/Reserve ratio : 50
 Non bank public's D/C ratio : 9.98
 (DISEQUILIBRIUM)

STAGE 3: EQUILIBRIUM RESTORED (figures have been rounded)

Exchange Fund	
Foreign Exchange 590	CIs 599
HK\$ Deposits 9	

Commercial Banks

CIs 599	Banknote issue 599
Till cash 100	Deposits of non bank public 4991
Loans and Investments 4900	Deposits of Exchange Fund 9
Foreign assets 10	Foreign currency deposits of non bank public 10

Non Bank Public

Banknotes 499	
Deposits 4991	
Money Supply : 5490	
Foreign currency deposits 10	

Banks' Deposit/Reserve ratio : 50
 Non bank public's D/C ratio : 10
 (EQUILIBRIUM)
 Original Intervention : -10
 Change in money supply: -10

mistakenly defined to include deposits of the authorities, not because the public's holdings of money have changed.)

It is not surprising in view of these fundamental deficiencies in the Hong Kong banking system that the money supply has continued to balloon and periodic government intervention in the foreign exchange market has had no effect. Since intervention is not effective under present institutional arrangements it is not surprising that the government is reluctant to manage the exchange rate in the way that Australia, Malaysia, Singapore and other economies have done in recent years. But this should not be allowed to remain an excuse for inaction. Active intervention may have proved futile given the present system, but that does not necessarily mean that another set of institutional arrangements could not be effective. In particular there is nothing sacrosanct about the new HK\$ accounts that the Exchange Fund set up around 1972. If they were to be properly rearranged in such a way as to correct the mistakes of 1972-74, then there would be some prospect that Hong Kong could return to the exemplary path of high real growth with low inflation and a strong currency.

However, under present institutional arrangements neither pegging the exchange rate nor controlling the reserves of the banks as a means of controlling the money supply is feasible. The plain fact is that given the present set-up with the Exchange Fund holding local currency deposits in the banking system (rather than the other way round) there is no way of successfully controlling the supply of money either directly via the reserves of the banks or indirectly through managing the foreign exchange rate - despite all rhetoric about the "interest rate weapon".

The solution to Hong Kong's monetary problems requires rectifying the mistakes of 1972-74, and instituting a simple and effective banking structure which ensures that in the long term Hong Kong can again enjoy overall price stability. At the same time it is desirable that the characteristics which have made Hong Kong's economic performance so successful are preserved. The options available together with the basic legislative changes required to implement them were set out in Asian Monetary Monitor two years ago (AMM Vol. 3 No. 2, March-April 1979), and still hold good today.

Briefly the two options are either to control the quantity of money directly by first redefining and second regulating the quantity of HK\$-denominated reserves held by the banks, or to control the external value of the currency in such a way that the adjustment mechanism operates to regulate monetary growth in Hong Kong so as to keep overall prices in Hong Kong internationally competitive at the chosen exchange rate.

However, the first thing to be done before either of these proposals can be effective is for the Exchange Fund to close down its HK\$ accounts with the two note-issuing banks, and having done that, either to revert to its passive role of supplying CIs (or authorisations to print bank notes) at some

A MONETARY AUTHORITY WITH NO GOVERNMENT DEBT*

It is sometimes stated by private bankers and by public officials that the lack of any government debt in Hong Kong hinders the establishment of a Central Bank. This argument is mistaken. There is no reason why a Monetary Authority or Central Bank needs to conduct its operations in government debt, nor any reason why the Monetary Authority should hold any government debt as a part of its assets.

Consider the situation in Japan from 1949 to 1973. Throughout most of that period the Japanese government maintained a budget surplus so there was virtually no government debt, and yet the Bank of Japan supplied reserves to the banks either by purchasing foreign exchange and selling yen to the City Banks, or by discounting private sector export bills or by making direct loans to the banks. The Bank of Japan held almost no government debt. Yet despite this, the Bank of Japan was able to influence monetary growth upwards or downwards, and Japan accordingly experienced distinct phases of monetary acceleration alternating with periods of monetary deceleration.

Consider the situation in Singapore today. The Government of Singapore issues substantial quantities of debt, but almost all of it is purchased by the Post Office Savings Bank and the Central Provident Fund; almost none is purchased by the Monetary Authority of Singapore (MAS). The assets of the MAS consist mainly of foreign exchange (92% as at the end of March 1978) and the MAS conducts its operations for the most part in the foreign exchange market. Government debt exists, but, except for small-scale operations in Treasury Bills, it is not central to the conduct of monetary policy.

It is true that Central Banks such as the U.S. Federal Reserve System or the Bank of England conduct their open market operations largely in government debt, but there is absolutely no reason why this should necessarily be so. The U.S. Federal Reserve could purchase Commercial Paper or Bankers Acceptances instead of Treasury Bills and Government Securities, and the Bank of England could equally well buy or sell private sector paper instead of Treasury Bills whenever it wishes to adjust liquidity in the system. Indeed the Fed and the Bank of England do buy and sell private sector debt instruments in the course of their open market operations. The crucial point is that irrespective of the particular instrument employed in these central bank operations, there will be a multiple expansion effect or a multiple contraction effect on the banking system as a whole resulting from the original purchase or sale by the central bank.

In short, the proposition that Hong Kong's lack of government debt makes it difficult to establish a Monetary Authority or central bank is a red herring. The only logical consequence is that the assets of the monetary authority would have to be comprised of instruments other than government debt, i.e. foreign exchange or private sector debt instruments such as export bills or certificates of deposit.

* This is a slightly revised version of the 'box' which was published in AMM in March-April 1979.

announced rate - which need not be constant - in terms of foreign currency (or currencies) with the basic idea of setting the external value of the currency and leaving the domestic money supply to look after itself, or to decide once and for all to become an honest-to-goodness central bank with the full panoply of instruments necessary to vary the reserves of the banks (or the monetary base) in such a way as to regulate the overall rate of monetary growth.

The details of the transition from the present system to a central bank system controlling money supply are straightforward in principle but would be complicated to implement and would require a wide measure of cooperation from government departments and the licensed banks. Moreover, once implemented such a system would encounter tricky problems involved in defining the operating procedures, in maintaining the impartiality appropriate to a central bank, and in deciding on a rate of monetary growth appropriate to Hong Kong's circumstances. (See AMM Vol. 3 No. 2 p. 15 for further disadvantages of this scheme.)

But the key question which the authorities will have to face sooner or later is how long can Hong Kong afford to continue with the present makeshift monetary system? How far does the exchange rate have to decline and how high does inflation have to rise before it is time to call a halt?

Already in December 1979 rent controls were imposed on private residential accommodation in a misguided attempt to suppress the symptoms of inflation instead of tackling the root causes of the problem. Like governments in other countries which have embarked on such a programme the Hong Kong government has claimed that rent control is purely a temporary measure. Yet the clamour for extension of the legislation when it expires in December 1981 is likely to be overwhelming. As the inflation intensifies more and more lobby groups are clamouring for special interest legislation to protect them from the effects of higher prices - public bus users who want fares to be subsidised, small shopkeepers who want rents on commercial premises to be controlled, and so on. The danger is that Hong Kong will progressively abandon the free market which has served it so well because the authorities are failing to deal with the problem of inflation at its source by correcting the deficiencies of the monetary system.

Meanwhile by imposing rent controls and thus preventing the property market from acting as the hedge against inflation that it normally would be, the rent control legislation is encouraging more and more people to look elsewhere and particularly abroad for a safe haven from the depreciating domestic purchasing power of the currency. That trend has been accentuated by the loss of confidence in the stock market. As a consequence it is likely that the Hong Kong dollar will continue to depreciate on the foreign exchange market, and then the danger is that the depreciation of the Hong Kong dollar will be blamed for inflation. Next, the wrong diagnosis could elicit further mistaken treatment, such as credit controls or another

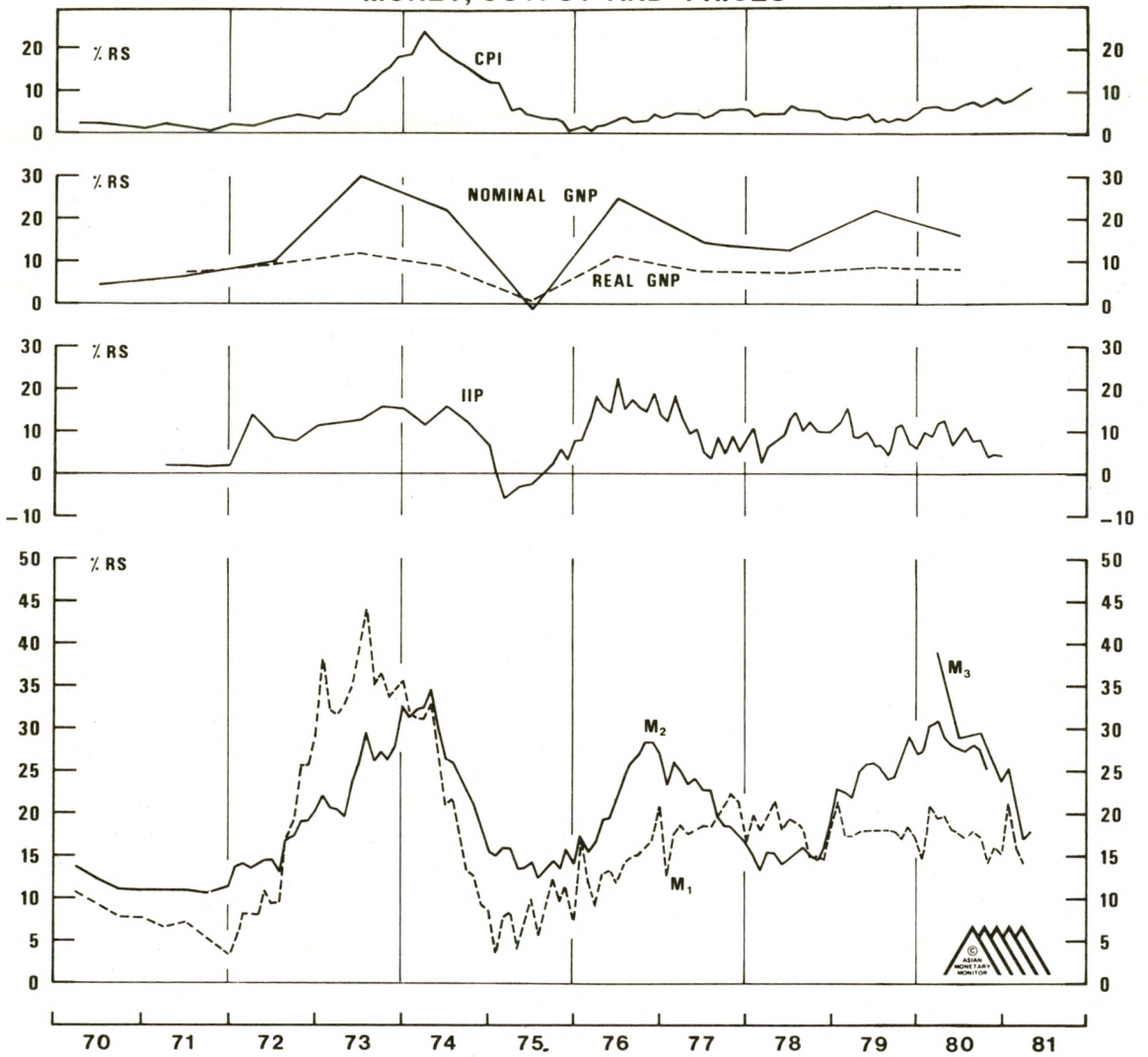
attempt to reinforce the Interest Rate Agreement, which would further damage the vital fabric of Hong Kong's free market economy and yet the disease would still persist.....

It is time to blow the whistle on Hong Kong's monetary system.

MALAYSIA

CHART 1

MONEY, OUTPUT AND PRICES



MALAYSIA

A SEVERE CYCLICAL DOWNTURN

During 1979 and 1980 the Malaysian economy generated a fine list of credentials. In contrast to the recessionary environments typical in Europe and the US, and the slower growth evident in Japan, nearly all indicators in Malaysia pointed to a buoyant economy and apparently sturdy growth. Consumer price inflation averaged an impressive 3.6% during 1979 before increasing to a relatively modest 7.1% in 1980. This was at a time when many other countries experienced double-digit rises in consumer prices. Interest rates, too, remained low from any international perspective. Money market interest rates in Malaysia actually declined on a year-to-year comparison during 1979 and traded below 8% for most of 1980. Perhaps the most notable contrasts, however, lay in Malaysia's continued high rate of economic growth. Real Gross Domestic Product expanded by nearly nine percent in 1979 and slowed only marginally during the following year.

Economic vitality in the domestic sector was matched by strength in Malaysia's external accounts and in its net external reserve position. Malaysia's trade surplus in the year to March 1980 was more than M.R. 7 billion, or over twice the surplus earned during 1978. In the same period Malaysia's net external reserve position* improved nearly 45% to reach a near record M.R. 9.68 billion in March 1980. Throughout 1979 and 1980 the Ringgit remained generally firm against the strengthening US dollar. Of course, over the short to medium term this reflected the Bank Negara Malaysia's (BNM's) policy of managing the Ringgit against a basket of currencies, but the combination of economic circumstances outlined above provided fundamental backing to the currency.

It is important to realise, however, that the buoyancy apparent in the Malaysian economy was the result of a cyclical boom rather than the consequence of a transition to sustainably higher levels of economic activity. Stronger growth in the domestic economy in 1979 and 1980, which fuelled a sharp rise in property and equity values, followed a large expansion in monetary growth. M2 accelerated from a cyclical bow of 13.2% in February 1979 to a peak of 31% in March 1980. The reasons behind this excessive monetary creation were discussed in AMM Vol. 3 No. 5 where it was concluded that the Bank Negara Malaysia's (BNM) steady acquisition of foreign exchange (see Chart 2) must have been paralleled by a gradual increase in reserve assets in the banking system. This steady rise, which followed as a result of an increased external surplus, laid the basis for a large expansion in banks' balance sheets and monetary growth.

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* Net external reserves are defined as the sum of official foreign reserves, net balances at the IMF, gold, and the net foreign assets of commercial banks.

This cyclical trend has now been reversed and, indeed, all major economic indicators have deteriorated during the last twelve months. There have been at least four major contributors to the recent cyclical downturn in the Malaysian economy. The most important of these has been a rapid decline in Malaysia's trade surplus. Malaysian exports have suffered considerably as a result of the overall downturn in basic commodity prices. Chart 3 indicates that total exports fell by 2% during 1980, after growing by no less than 37.5% in the previous year. Import growth has also declined though the fall has been more moderate reflecting the fact that aggregate demand in the domestic economy continued relatively firm last year. Malaysia's huge trade surplus evaporated as these trends evolved: the trade account was roughly in balance by the end of 1980 in contrast to a M\$1.5 billion surplus in the final quarter of 1979. The cyclical fall in the trade surplus almost certainly explains why Malaysia's net external reserve position began to level off during 1980 and is now showing signs of an absolute decline. Similar slowdowns in the net foreign exchange position occurred following cyclical contractions in the trade surplus in 1974/75 and in 1978. (Compare Charts 2 and 3.) This in turn has signalled the reduction in monetary growth evident since the middle of last year.

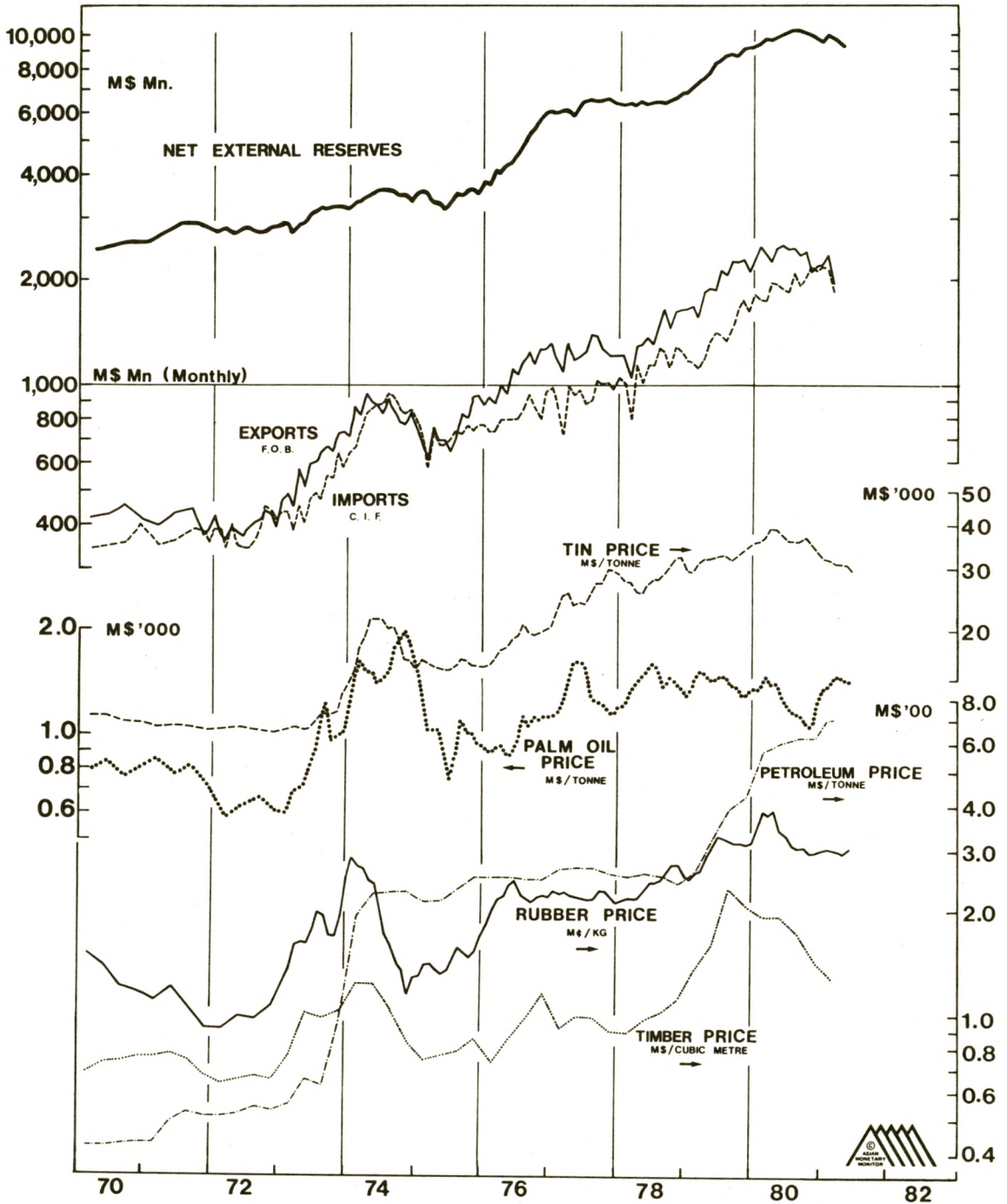
Thus, one straightforward way to interpret the Malaysian business cycle is in terms of the domestic economy reacting, with a lag, to changes in both export earnings and relative prices. On this basis slower growth in Malaysia follows as a result of a declining trade surplus and rising inflation - the latter being a second important contributor to Malaysia's cyclical contraction.

However this orthodox analysis of the business cycle, whilst shedding some light on current trends in the Malaysian economy, is incomplete. It is based on the assumption that the Ringgit is pegged directly to a particular foreign currency whereas, in fact, the BNM has managed the Ringgit against a basket of currencies since September 1975. In principle, the BNM can manage the Ringgit so as to dampen cyclical swings in the trade and current account position, and thereby reduce cyclical deviations in monetary growth. This type of managed exchange rate policy effectively amounts to indirect control over monetary growth. This policy may be complimented if, at the same time, the Bank Negara Malaysia exercises a measure of direct control over the money supply.

This is in fact exactly what the BNM tries to achieve. It manages the exchange rate against an undisclosed basket of currencies whilst simultaneously setting annual monetary growth targets. If successful this policy should prevent a succession of cyclical booms followed by cyclical slowdowns in the Malaysian economy.

A comparison of Charts 1 and 2, however, confirms that the BNM's economic stabilisation policies have not been particularly successful. It is clear that during 1979 and 1980, the Malaysian authorities did not move sufficiently forcefully in

MALAYSIA
CHART 2 : TRADE AND COMMODITY PRICES



allowing the Ringgit to appreciate against other currencies.

This is illustrated by the large increase in both Malaysia's trade surplus and in its net foreign exchange position. In other words, indirect control of the money supply in this period was not sufficiently stringent, and resulted in excessive monetary growth and relatively low interest rates during 1979 and 1980.

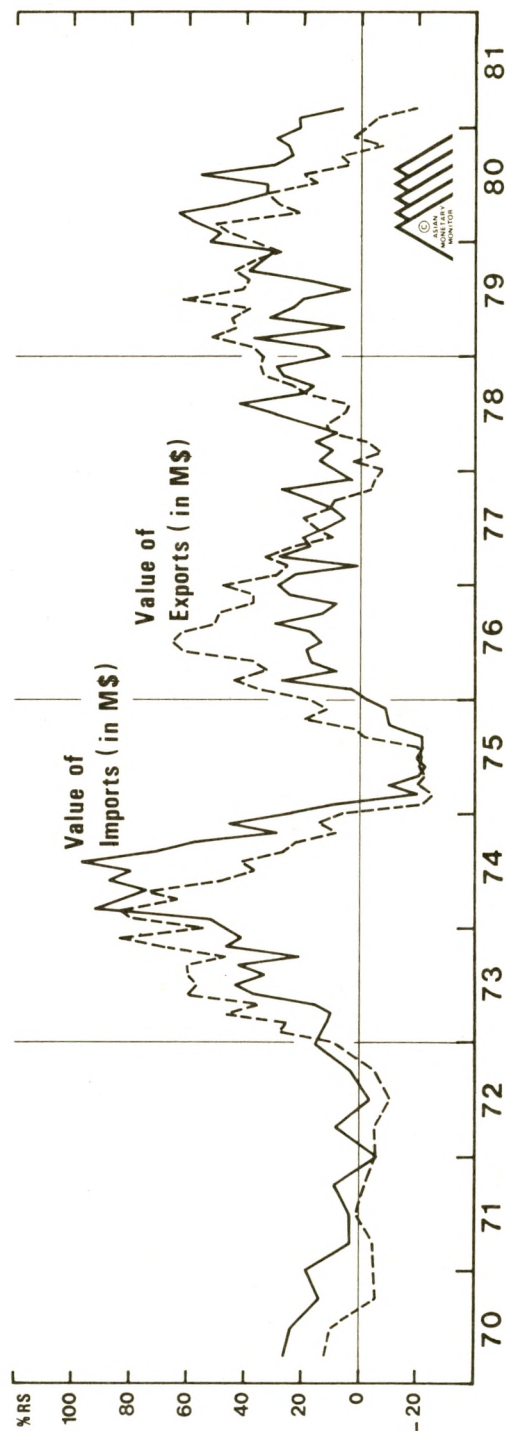
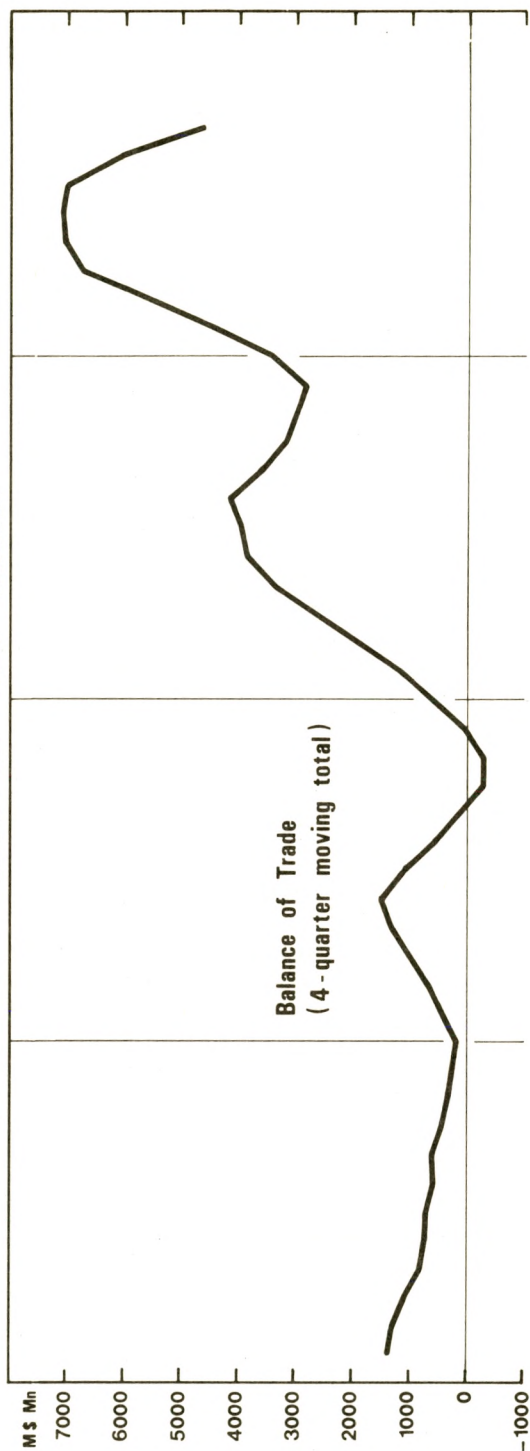
However, the BNM could have offset the potential surge in monetary growth through direct action in the domestic money markets. This would have entailed upward pressure in local interest rates as the BNM sold government debt in the money markets. Although there is some evidence that this occurred - the BNM reduced its holdings of government securities by 15% in 1979 - it was not sufficient to avert the sharp increase in monetary growth. Part of the reason for this is that the BNM's monetary target is couched in terms of M1 - one of the narrower monetary aggregates. The BNM allowed interest rates to rise such that M1 growth was maintained close to the upper end of its 11%-15% target band during 1979 and 1980. The small rise, however, was not enough to prevent large increases in the wider aggregates. Thus, an undervalued currency (in the context of economic stabilisation policy) and relatively low interest rates were important factors behind the cyclical boom in 1979 and 1980.

The corollary is now true. In the context of a declining balance of trade position, the Ringgit is now "overvalued". This represents a third reason why the Malaysian is in a period of cyclical decline. The final reason is that domestic interest rates are now too high. The monetary base in Malaysia declined, in absolute terms, by over 12% from October 1980 to April of this year. If the Malaysian authorities wish to resist the cyclical slowdown then, given the fall in net foreign exchange reserves, they must deliberately lower local interest rates. If interest rates remain at their current level, the growth in banks' balance sheets will continue to slow. The start of this process is illustrated in Chart 4.

The reasons behind the start of the recent slowdown in the Malaysian economy suggest various policy options which are now open to the Malaysian authorities. They can act to reverse the monetary slowdown either directly by reducing domestic interest rates, or indirectly through a devaluation, or they may decide to allow the business cycle to take its 'natural' course. From the evidence of previous business cycles, adoption of the final choice implies that there will be no recovery in the Malaysian economy until world trade and basic commodity prices begin to improve. On current world trends it is possible that an export led recovery may not materialise for some time. The most important question, therefore, is whether the Malaysian authorities can tolerate the prospects of what may well turn out to be a fairly lengthy cyclical slowdown.

At present it appears that the Malaysian authorities are in fact going to try and sit through the cyclical downturn. There are various pieces of evidence to support the view that

Malaysia
Chart 3: The Trade Account

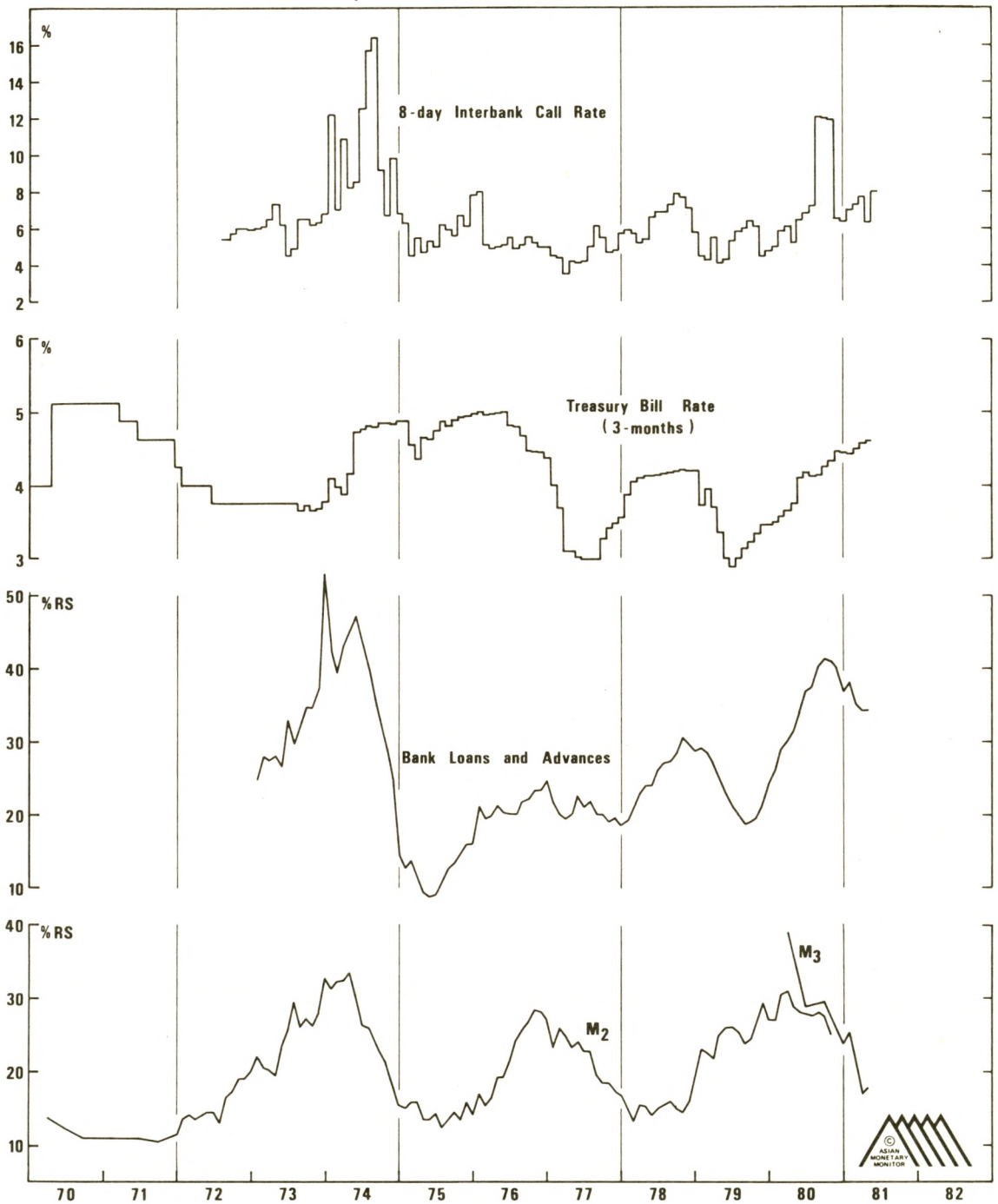


they will not attempt to offset the drain on domestic liquidity following the deterioration in Malaysia's external sector. The first of these is a recent statement by the BNM that it has revised its M1 growth target down to 11% in the year to June 1982. M1 grew by 17.6% in the year to April and, if the new target is successfully achieved, it would represent the lowest rate of M1 growth since April 1976. This target growth path would be consistent with a continued slowdown in the Malaysian economy into 1982. The BNM's recent activity in the local money markets also adds support to the view that it is not attempting to reverse the decline in monetary growth. One way that the BNM could try to offset the impact of a decline in net foreign exchange reserves would be to boost its holdings of Government debt. Thus any rise in the BNM's holdings of Government debt could be interpreted as a stimulative policy move aimed at increasing domestic liquidity and easing local interest rates. However the BNM actually reduced its holdings of federal government securities by over 40% between September 1980 and April of this year. More importantly, holdings of government debt are typically only a relatively small proportion of the BNM's overall balance sheet. In the autumn of last year government debt rose to nearly 20% of the BNM's total assets, but this was an unusual period and generally government securities form between only 5% and 10% of the BNM's balance sheet. Gold and foreign exchange assets are by far the most important item in the BNM's balance sheet. They comprise up to 90% of its assets. Thus for the BNM effectively to offset a decline in its international reserve position it would need to substantially restructure its asset portfolio. Whilst this is not inconceivable, it would mark a significant break from previous policies.

One other recent policy announcement also implies that the Malaysian authorities are unlikely successfully to offset the external drain on monetary growth. Pertiminas, the state owned oil company, has stated that it will reduce its oil exports by 15% in the forthcoming year. At current oil prices this implies a reduction in total export revenues of about 1 billion Ringgit. Although not all oil revenues are converted into local currency, this reduction in oil output may cut Malaysia's total export revenues by as much as 5%. It seems, on existing policies at any rate, that the Malaysian authorities are prepared to see the external drain on domestic liquidity continue, and perhaps intensify, rather than sell national assets at what may prove to be cyclically low prices.

In the final analysis, of course, the choice between whether to allow the squeeze to run its course or depreciate the currency (either immediately, as a result of devaluation or slowly, following the BNM's monetisation of government debt) will reflect political preferences for growth over price stability in the short to medium term. We would point out, however, that Malaysia's inflation rate this year is very likely to exceed that in the US. This will be the first year this has occurred since 1974. If the Malaysian government decides to resist a squeeze, downward pressure on the Ringgit will intensify, and the deterioration in Malaysia's relative

Malaysia
Chart 4
Monetary Growth, Loan Growth and Interest Rates



inflation rate will persist in the medium term. Higher inflation will tend to reduce the secularly high growth rate in Malaysia by distorting resource allocation through the price mechanism, undermining domestic political stability, and reducing foreign investor confidence. It is sincerely to be hoped that the Malaysian authorities do not attempt to reverse the cyclical contraction now under way.

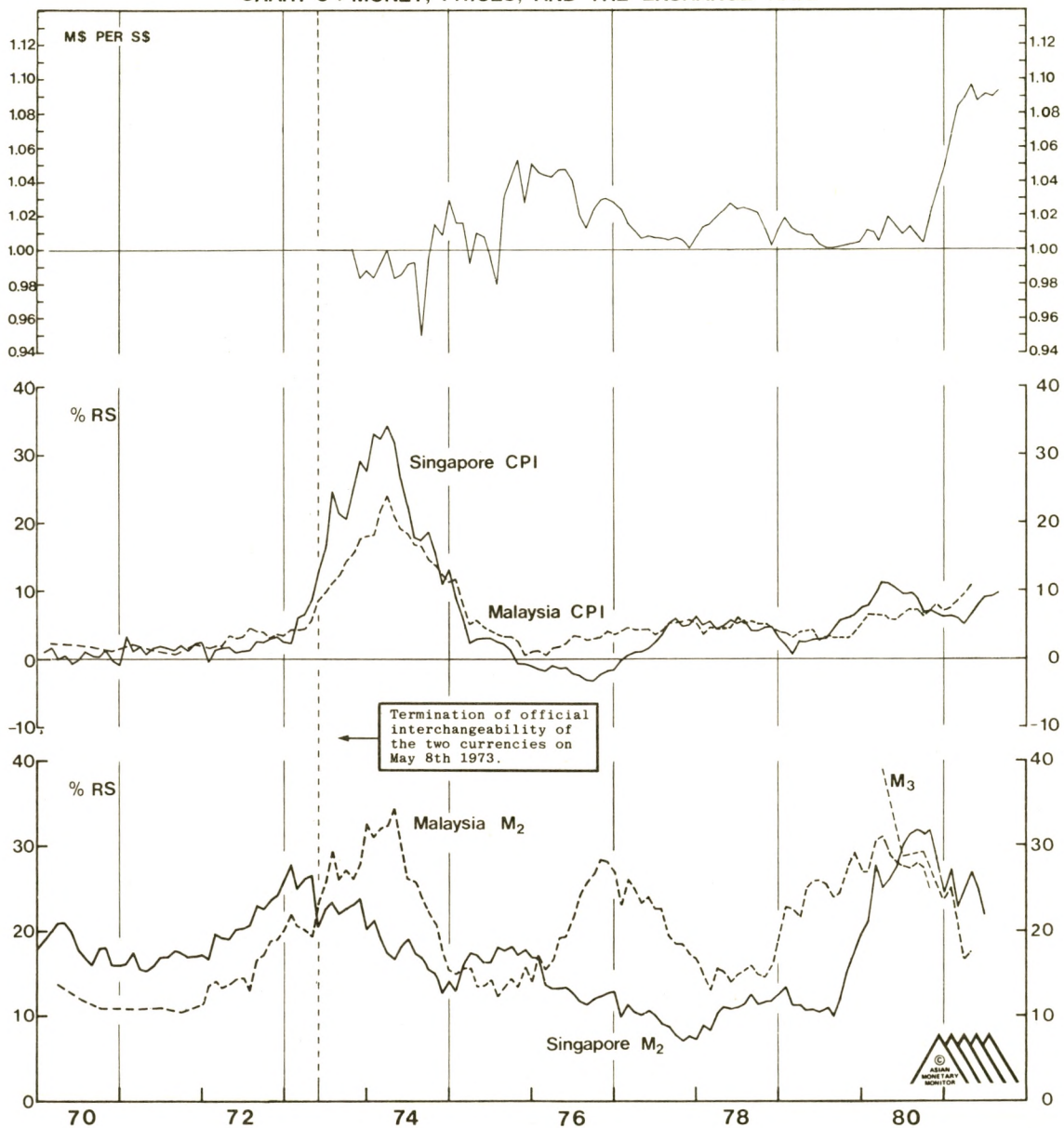
There are, however, two gleams of sunlight in an otherwise cautious assessment of cyclical trends in the Malaysian economy. First, providing the squeeze is allowed to continue, consumer price inflation is likely to peak out either in the final quarter of this year or during the first quarter of 1982. This follows as a direct consequence of the sharp monetary contraction which began during the first half of 1980. Second, the Malaysian Ringgit is unlikely to fall to a deeper discount against the Singapore dollar. The decline in the Ringgit from close to parity in the third quarter of 1980 to a 9% discount took place against the backdrop of a declining external surplus and a deteriorating relative inflation rate. A similarly based decline in the Ringgit - Singapore dollar rate took place in 1975 (see Chart 5). However, the recent monetary squeeze in Malaysia has been relatively more severe than in Singapore, and the latter must also pay the price - in terms of higher inflation - for an excessively easy monetary policy during 1980. On this basis we expect Malaysian inflation to improve relative to that in Singapore over the course of the next eighteen months. In past business cycles (e.g. the first three quarters of 1978, mid-1976 to late 1977, and again during 1979) this has led to an appreciation of the Ringgit against the Singapore dollar. Providing the monetary authorities do not attempt to reverse the current liquidity squeeze we anticipate that the Ringgit will appreciate against the Singapore dollar over the next year.

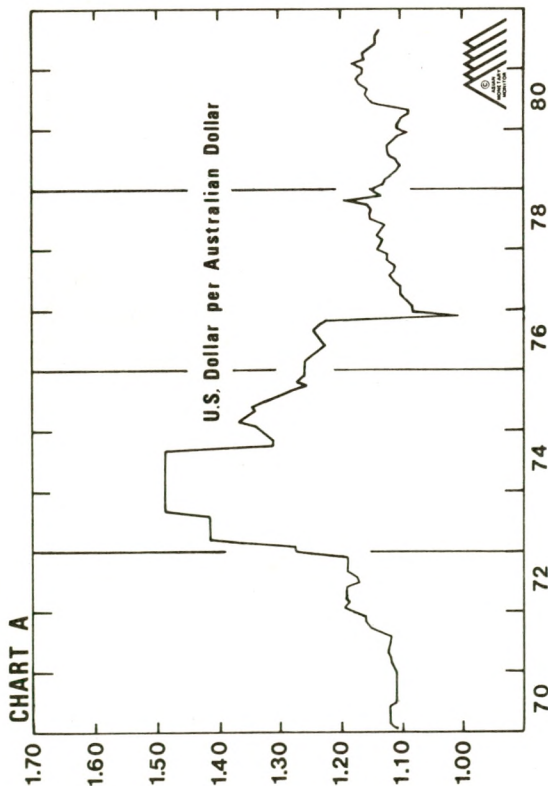
FORECAST: Malaysia's real economic growth rate will decline significantly during 1981 and 1982 in comparison with recent experience. The cyclical slowdown in the economy is a direct result of a sharp contraction in monetary growth which began during the first half of 1980 and is continuing. The monetary squeeze will be sustained whilst Malaysia's external position continues to deteriorate and so long as domestic interest rates remain at their current levels.

Malaysian interest rates will decline during 1982 but this should probably be interpreted as a normal consequence of the cyclical slowdown and will be associated with further falls in credit growth. It appears unlikely, at this stage, that the Malaysian authorities will deliberately reduce interest rates and maintain them at artificially low levels in an attempt to reverse the cyclical contraction.

Although both interest rates and inflation are likely to decline next year it is improbable that this will be of positive benefit to the local property and equity markets. On the evidence of past business cycles, another sustainable bull market in Malaysian equities must await a revival of basic commodity prices and a cyclical upturn in monetary growth.

SINGAPORE AND MALAYSIA
 CHART 5 : MONEY, PRICES, AND THE EXCHANGE RATE





The Australian dollar has proved one of the world's strongest currencies this year. It has fluctuated narrowly within the US\$1.12 to US\$1.18 range since the end of 1980, and this has resulted in an appreciation of around 20% against the European currencies and nearly 15% against the yen.

The relative strength of the Australian dollar has been supported by a marked reduction in the interest rate differential favouring the US dollar. Short term interest rates in Australia have risen appreciably since the beginning of the year. Trading Bank Certificates of Deposit rates, for example, have risen from an average of 11.46% in December 1980 to over 16% in June of this year. Whilst in the current exchange rate environment such increases are usually beneficial for a country's currency, in Australia's case the rise in short term interest rates may well indicate potential weakness in the Australian dollar in the medium to longer term.

The reason for this lies with the fact that the Australian business cycle is substantially out of phase with many of its OECD trading partners. It is one of the very few economies world wide not to have suffered a slowdown in economic activity sometime during the past two years. Real GDP increased nearly 4½% in calendar 1980

and inflation, as measured by the GDP deflator, has steadily increased to 10.3% in the year to June. The rise in inflation has been fuelled by the Reserve Bank's failure to restrict monetary growth to a non-inflationary level. The rise in M3 has exceeded its target in each of the last three years. The high level of interest rates, therefore, are primarily the result of rising inflationary pressures and a strong level of economic activity rather than a squeeze in the domestic economy. One of the consequences of a domestic boom in Australia whilst elsewhere economic activity is depressed and inflation falling has been a marked deterioration in Australia's current account (see Chart B). This suggests that the Australian dollar is becoming increasingly uncompetitive as a result of strong import demand and a worsening of Australia's relative inflation rate. This in turn implies that the Reserve Bank's policy of appreciating the Australian dollar against its trade-weighted index (it has risen 10% in the last year) is unlikely to continue, particularly if there is any reduction in the very large private capital inflows which have financed the current account deficit over the last two years.

We do not anticipate any major moves in the Australian dollar - US dollar exchange rate during the next six months but remain of the opinion, however, that the Australian dollar is overvalued on a longer term view.

ACTUAL FORECAST

US\$/A\$	1981	Q2	Jul.-Aug.	Q4	1982	Q1
FORECAST A						
Actual Range						
FORECAST B						

Forecast A assumes there is no significant decline in US interest rates for the remainder of the year.

Forecast B assumes that US interest rates decline fairly gradually from close to their current levels at some stage during the remainder of this year.

CHART B
TRADE PERFORMANCE

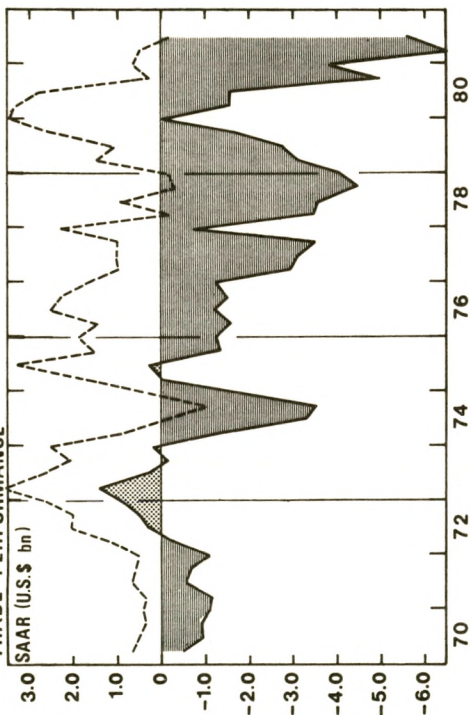


CHART C
INTEREST RATE DIFFERENTIAL

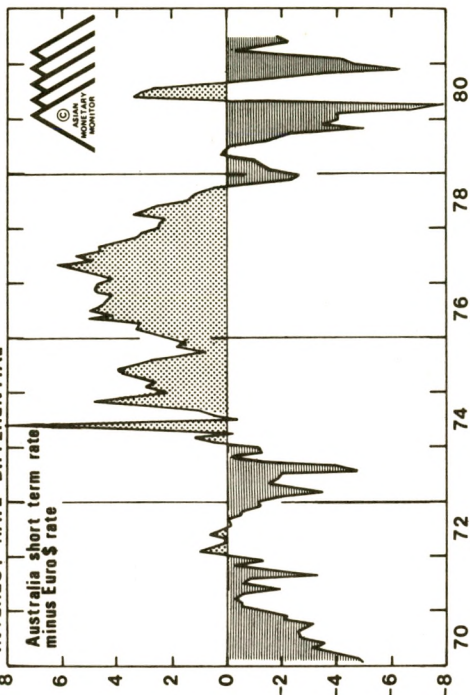


CHART D
PRICE COMPETITIVENESS (adjusted for exchange rate changes)

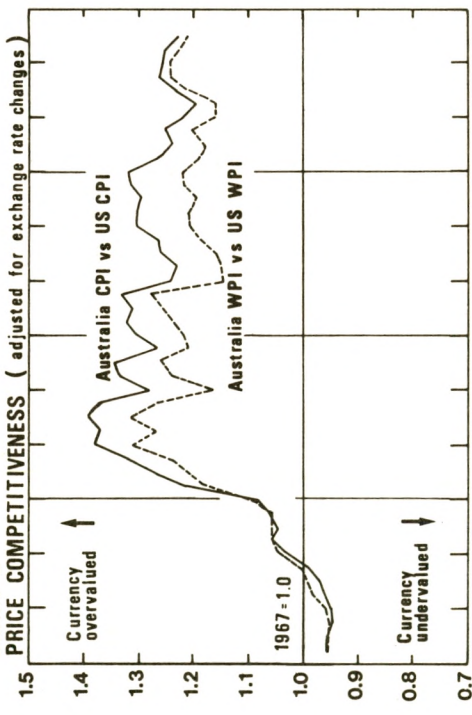
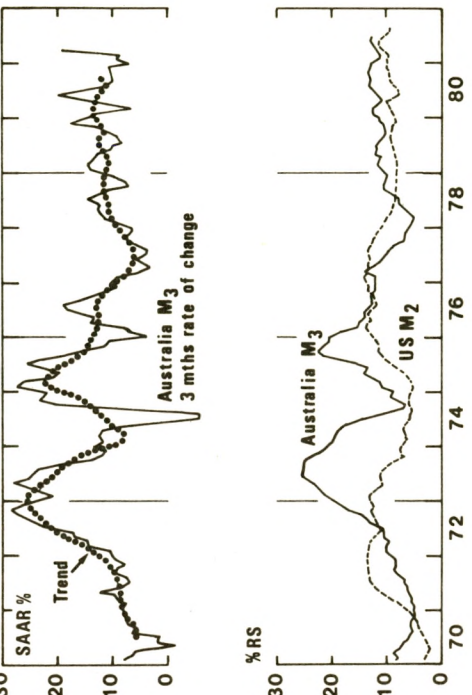
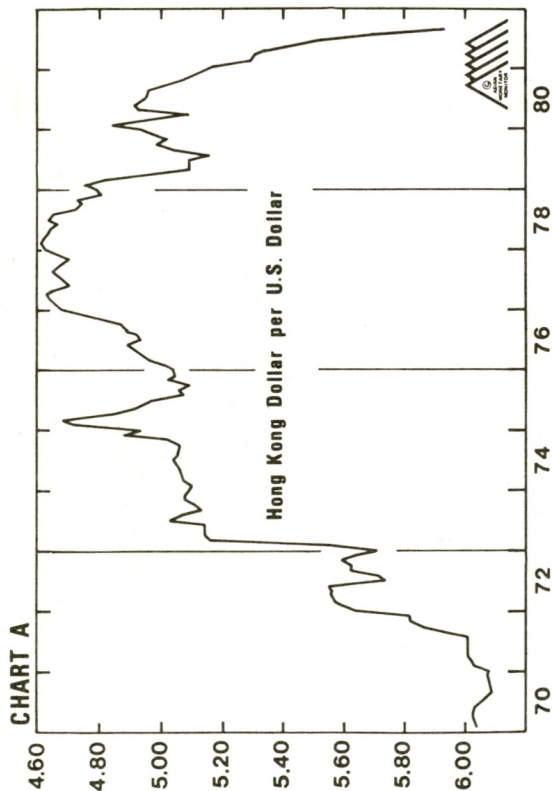


CHART E
RELATIVE MONEY GROWTH



SAAR: SEASONALLY ADJUSTED AT ANNUAL RATE
RS: RATE OF CHANGE OVER SAME MONTH OF PREVIOUS YEAR



The H.K. dollar remains fundamentally weak. The trends in monetary growth, inflation, and the trade balance continue to suggest further depreciation against the US dollar and, over the longer term, against the other major currencies.

The background to the H.K. dollar's weakness lies with excessive monetary growth in the domestic economy. This is illustrated in Chart E. The year-on-year increase in M3 has hovered close to 40% since the second quarter of 1980 in spite of a substantial rise in local interest rates: the Best Lending Rate, for example, has been raised from 10% to 18% during the course of the past year. Excessive increases in the money supply have led to a deterioration in a number of key economic indicators. The most important of these is that inflation has accelerated and measured 16½% in the year to May. Hong Kong's balance of trade also continues to be weak (see Chart B). The demand for imports has remained strong (rising 30% in the year to June) in spite of the decline in the H.K. dollar. This reflects the buoyant state of the domestic economy, and large increases in nominal incomes.

During July the local authorities allegedly intervened in support of the H.K. dollar against the rising US currency. At that

time the H.K. dollar was trading around HK\$5.65. Shortly after, on July 17th, the Hong Kong & Shanghai and Chartered Banks announced a general one percent increase in local interest rates that raised Best Lending Rate to a record 18%. It was officially announced that the primary reason for the hike was concern over the weakness of the H.K. dollar and higher import costs. However, we are confident that neither of these measures will stem a general depreciation of the H.K. dollar. The reasoning is straightforward and will be familiar to regular AMM readers. Under present institutional arrangements, an increase in local interest rates does nothing whatsoever to limit the availability of reservable assets to the banking system. Thus there is nothing to prevent banks bidding for additional deposits to meet further increases in loan demand. There is thus no reliable constraint on monetary growth. Similarly, H.K. dollars purchased in any official intervention on the foreign exchange ultimately end up deposited back in the banking system. There is no reduction in the amount of H.K. dollars on deposit, and again there is no constraint on the excessive monetary growth which we believe to be the basis for the H.K. dollar's depreciation.

The course of the H.K. dollar against the US dollar over the next two quarters clearly depends very much on the trend in US interest rates during this period. However, should US interest rates remain close to their current high levels, we feel that the H.K. dollar remains susceptible to further significant depreciation.

ACTUAL FORECAST

HK\$/US\$	1981 Q2	Jul.-Aug.	Q4	1982 Q1
FORECAST A				
Actual Range	5.28-5.56	5.56-5.98	6.10-6.50	6.40-7.00
FORECAST B			6.00-6.30	6.10-6.60

Forecast A assumes there is no significant decline in US interest rates for the remainder of the year.

Forecast B assumes that US interest rates decline fairly gradually from close to their current levels at some stage during the remainder of this year.

CHART B
TRADE PERFORMANCE

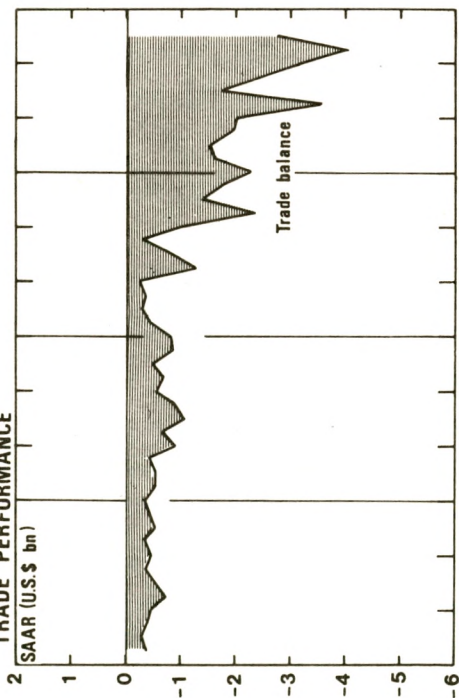


CHART C
INTEREST RATE DIFFERENTIAL

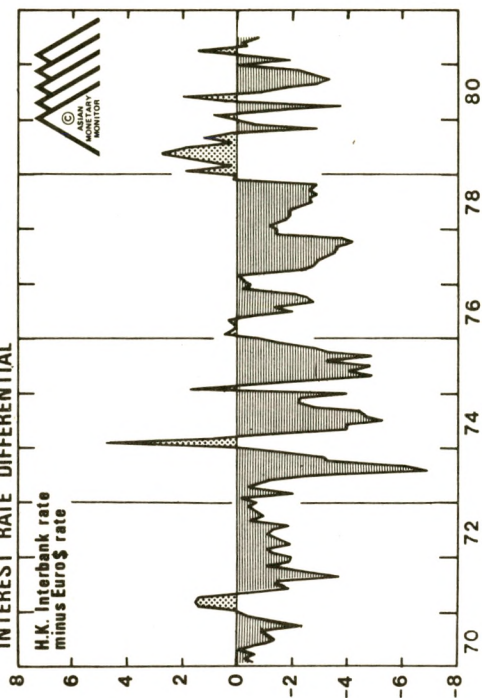


CHART D
PRICE COMPETITIVENESS (adjusted for exchange rate changes)

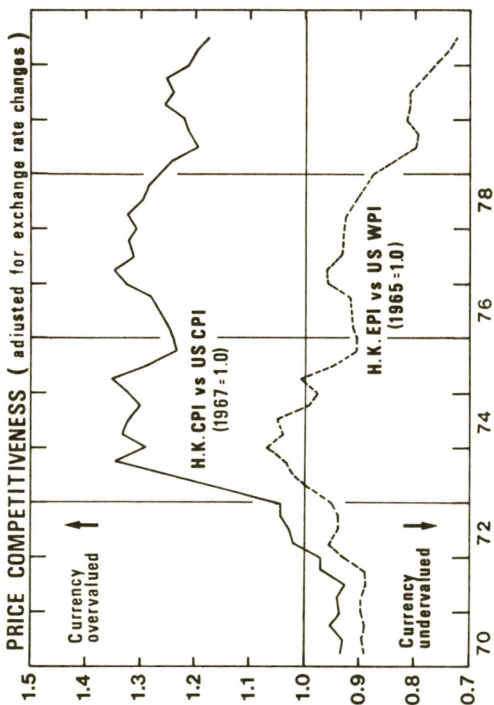
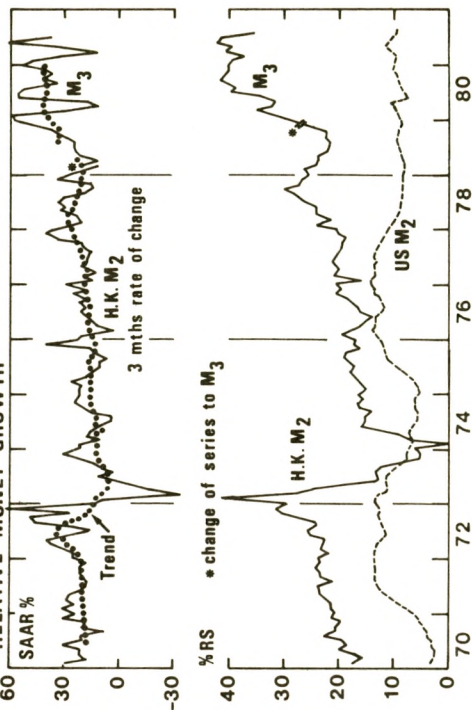
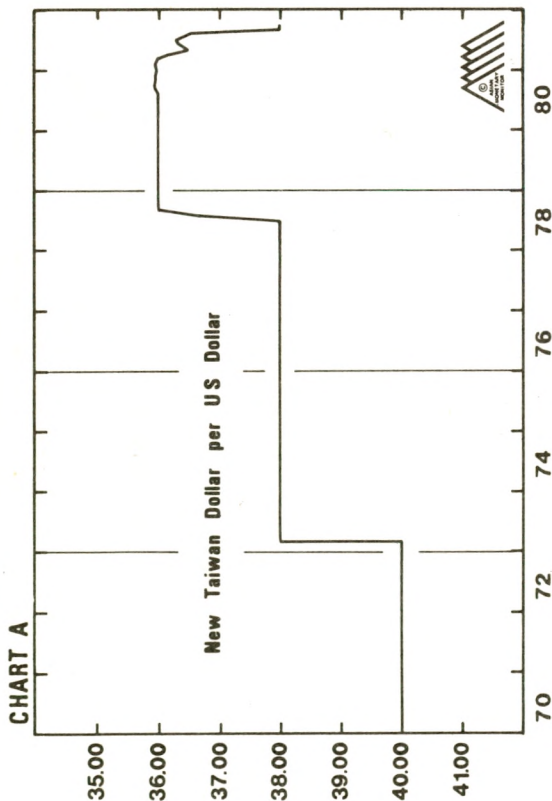


CHART E
RELATIVE MONEY GROWTH



EPI : EXPORT PRICE INDEX
SAAR: SEASONALLY ADJUSTED AT ANNUAL RATE
RS: RATE OF CHANGE OVER SAME MONTH OF PREVIOUS YEAR

NEW TAIWAN DOLLAR



The 4.8% devaluation of the NT\$ on August 14th brought its US dollar parity back down to the level it was pegged at from February 1973 to July 1978. This devaluation brings the Taiwanese currency closer into line with its notional, relative inflation adjusted, equilibrium level against the US dollar. Nevertheless, in view of the continued high rate of consumer price inflation during the past two years - consumer prices rose 18.5% in the year to June - we clearly need to assess whether or not the devaluation will be successful. Will it, for example, prove sufficient to reverse the deteriorating trend in Taiwan's current account evident since 1978, and will it improve the historically poor growth in output achieved last year when industrial production expanded a meagre 6.0%?

The root causes of the recent devaluation lie with the Central Bank of China's decision to revalue the New Taiwan dollar during 1978. At the time it appeared in many respects that this was a sensible policy. The US dollar was weakening rapidly against all major currencies, Taiwan's trade and current accounts were improving strongly (see Chart B), there was vigorous growth in industrial production, but the rapid growth in the monetary aggregates (see Chart E) risked reversing the large improvement in Taiwan inflation rate that had occurred since the middle of 1974.

(Consumer price inflation declined from 48.5% during the second quarter of 1974 to 1.5% by the end of 1976 and averaged 6% throughout 1978.) Nevertheless, it appears that the Central Bank of China reckoned without the impact of the quadrupling in oil prices during 1979 and, like many others, it failed to predict the prolonged periods of US dollar strength during 1980 and this year. For the impact of the rise in OPEC oil prices and a prolonged 'hard money' policy in the US produced a sharp squeeze on profit margins as wholesale prices accelerated from 2.6% in June 1978 to 24.7% in February 1980, and Taiwan's trade account collapsed. This turnaround in Taiwan's external account is reflected in the very large reduction in monetary growth evident in 1979. The result of these factors was a sharp reduction in output growth. The yearly increase in industrial production plummeted from a cyclical high of 33.8% in the third quarter of 1978 to 4% in August 1979. It appears that the squeeze on output, the decline in real growth from 13.9% in 1978 to 6.7% in 1980, and the erosion in the external account proved too painful. Devaluation is the easiest way out of those problems.

We feel that the currently high level of consumer price inflation, albeit declining, reflects the impact of high increases in input prices during 1980. The squeeze on monetary growth during 1979, and the relatively low growth during the last year will result in a continuing deceleration in consumer price inflation in line with falling wholesale price rises (7% in the year to June). The trade balance is thus likely to continue the improvement evident in the second quarter of 1981 and we are confident that the corollary of this will be buoyant rises in industrial output. A further devaluation of the NT\$ is unlikely in the medium term.

NT\$/US\$	ACTUAL		FORECAST	
	1981	Q2	Jul.-Aug.	Q4 1982 Q1
FORECAST A				
Actual Range		35.84-36.47	36.47-38.00	43.5
FORECAST B				38.0

Forecast A is based on a simple projection of relative price competitiveness shown on Chart D i.e. the exchange rate necessary to bring US and local price levels into line.

Forecast B is the most likely range in the absence of some major political or other external disruption.

CHART B
TRADE PERFORMANCE

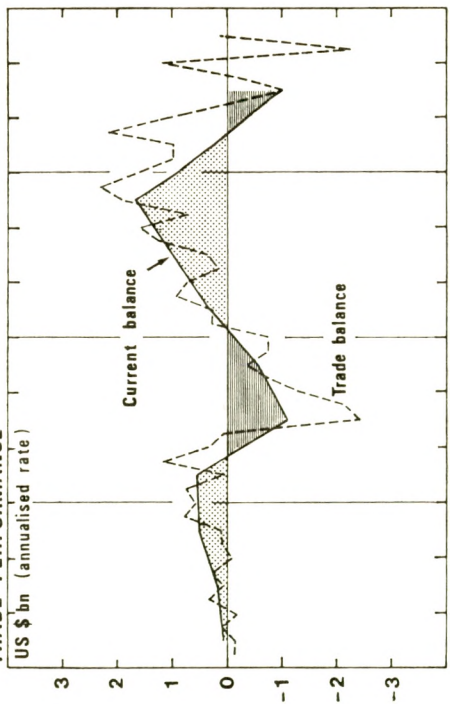


CHART C
INTERNATIONAL RESERVES

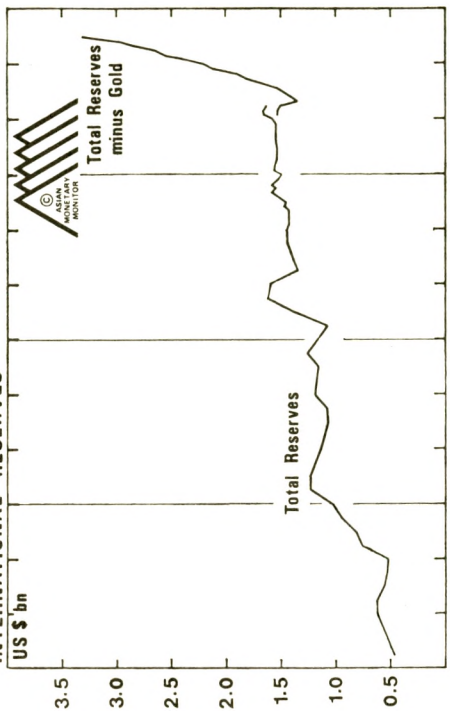


CHART D

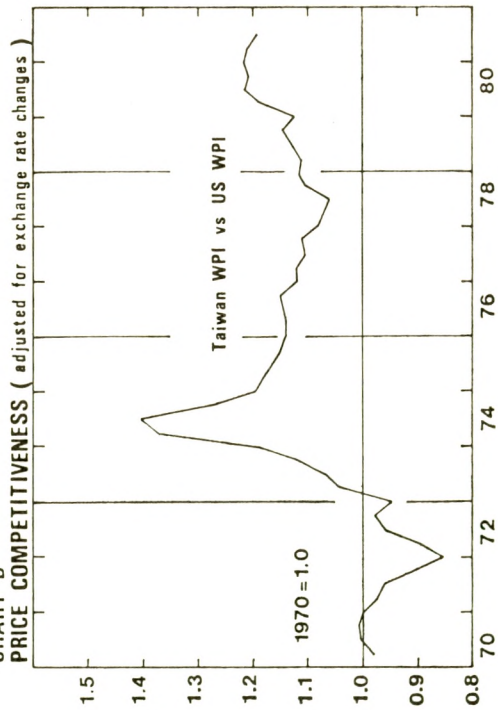
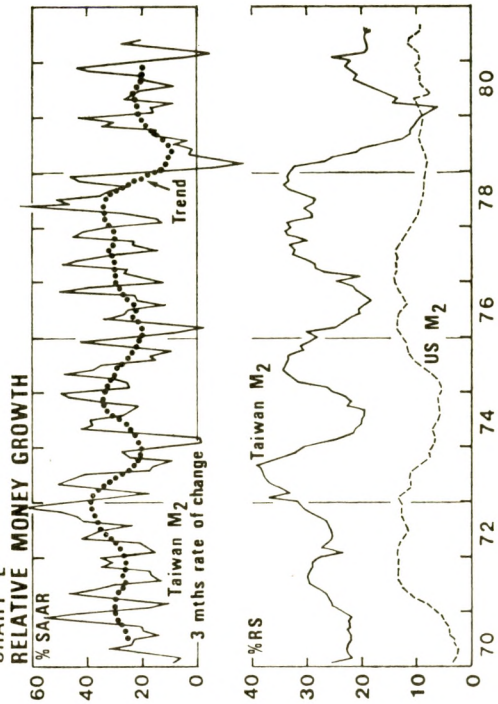


CHART E



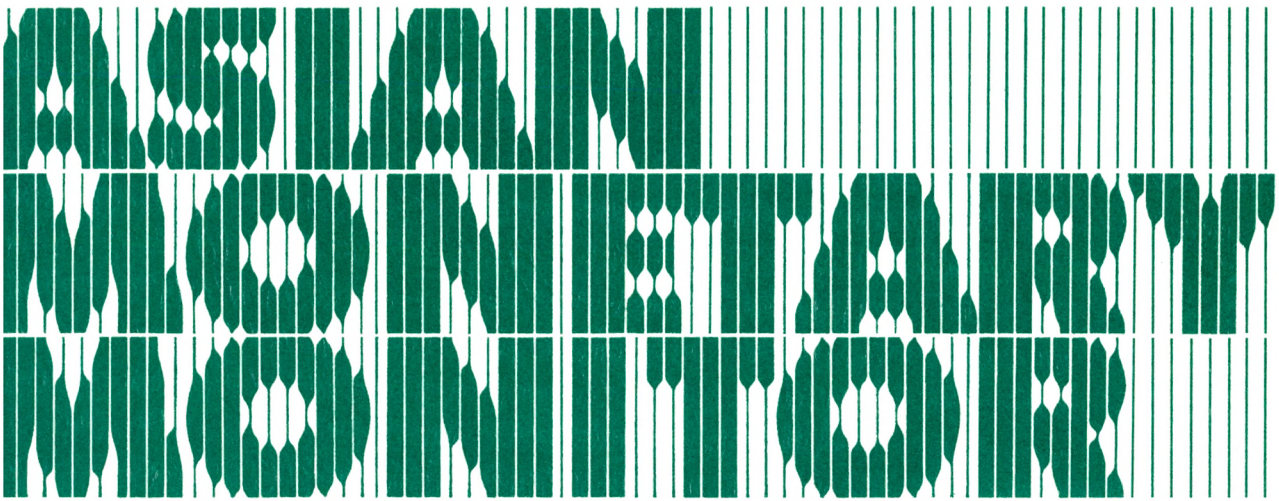
SAAR: SEASONALLY ADJUSTED AT ANNUAL RATE
RS: RATE OF CHANGE OVER SAME MONTH OF PREVIOUS YEAR



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CONTENTS

Page

HONG KONG:

The New Monetary Statistics

JAPAN:

Why has the Consumer Sector been so weak? 1

THAILAND:

Devaluation—and now Monetary Restraint? 2

EXCHANGE RATE FORECASTS:

Japanese Yen 3

Korean Won 3

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CONTENTS

	Page
HONG KONG	
The New Monetary Statistics	3
JAPAN	
Why has the Consumer Sector been so weak?	15
THAILAND	
Devaluation - and now Monetary Restraint?	26
EXCHANGE RATE FORECASTS:	
Japanese Yen	36
Korean Won	38

KEY TO SYMBOLS USED IN THE CHARTS

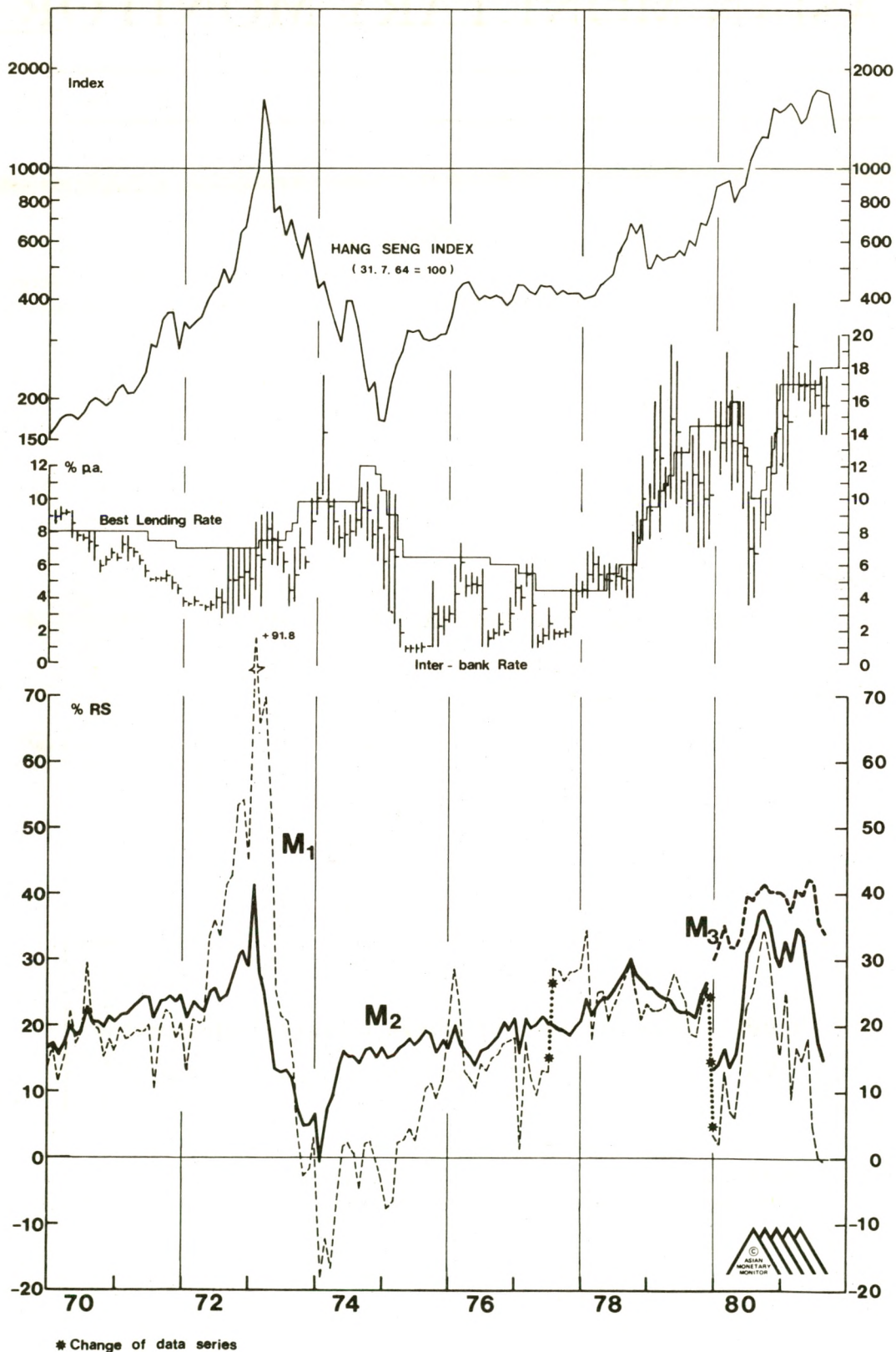
% RP - Percentage Rate of change over Preceding period.

% RS - Percentage Rate of change over Same period of preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

HONG KONG
 CHART 1: MONEY, INTEREST RATES, AND STOCK PRICES



HONG KONG

THE NEW MONETARY STATISTICS

The editors of Asian Monetary Monitor have long maintained that the Hong Kong banking statistics collected and published by the Commissioner of Banking were inappropriate for monetary analysis. In response to a growing awareness of the inadequacies of the existing statistics a Monetary Statistics Ordinance was put into effect last year, enabling the Secretary for Monetary Affairs to collect financial statistics from Licensed Banks and Deposit Taking Companies. These new statistics have now been collected for a number of months, and the results of the new classifications have given rise to a new set of money supply data. The new data were published for the first time at the end of August, showing month-end data from December 1980 to June 1981.

What do the new data show in terms of content? What do they reveal about the growth rate of the HK\$-denominated money supply which has been of so much widespread public concern in Hong Kong? And are there any remaining defects in the new statistics?

* * * * *

The main feature of the new banking statistics is the distinction made between HK\$-denominated assets and liabilities, and assets and liabilities denominated in foreign currencies. From the standpoint of monetary analysis we are interested in studying the relationships between the money supply in HK\$ and the various definitions of aggregate expenditures, and their division between the real economic activity component and the inflation component. To the extent that the revised statistics will permit this type of analysis to be conducted in the future, the new data are to be welcomed.

To ensure that there is a full year's overlap of the old data and the new data the authorities have agreed to publish the existing series of statistics each month until December 1981, and these will subsequently appear in the Monthly Digest of Statistics until December 1981. The new series will be published every month from now onwards, and will appear in the Monthly Digest of Statistics from January 1982, at which time the existing series of statistics will cease to be published, with the exception of the old-style liquidity ratio for banks and deposit-taking companies.

The new data permit us for the first time to set out the consolidated balance sheets for the banks and DTCs, showing the HK\$-denominated component for each item of assets and liabilities, and the corresponding foreign currency components. Table 1 on p. 4 sets out the HK\$-denominated elements, but for brevity - and because the exact composition of the foreign currency items is not of any great importance to us - we consolidate all the foreign currency items into one single

TABLE 1

Licensed Banks

	HK\$ mn		HK\$ mn
Notes and Coin	2,030		
Due from Banks & DTCs	27,040	Due to Banks & DTCs in HK	52,862
Due from Banks abroad	6,440	Due to Banks abroad	4,380
NCDs	298	NCDs	1,620
Loans & Advances	102,229	Deposits	82,756
BAs, Bills of Exchange	710		
FRNs & Commercial Paper	469		
Investments	5,299		
Other assets	12,915	Other liabilities	26,865
Subtotal	157,430	Subtotal	168,482
Foreign assets	184,443	Foreign liabilities	173,391
Total Assets	341,873	Total Liabilities	341,873

DTCs

	HK\$ mn		HK\$ mn
Notes and Coin	8		
Due from Banks & DTCs	38,245	Due to Banks & DTCs in HK	12,414
Due from Banks abroad	382	Due to Banks abroad	455
NCDs	964	NCDs	673
Loans & Advances	30,531	Deposits	47,463
BAs, Bills of Exchange	78		
FRNs & Commercial Paper	102		
Investments	2,974		
Other assets	2,566	Other liabilities	10,764
Subtotal	75,851	Subtotal	71,769
Foreign assets	108,249	Foreign liabilities	112,331
Total Assets	184,100	Total Liabilities	184,100

Aggregate Consolidated Balance Sheet for HK Banking System

	HK\$ mn		HK\$ mn
Notes and Coin	2,038		
Due from Banks & DTCs	65,285	Due to Banks & DTCs	65,276
Due from Banks abroad	6,822	Due to Banks abroad	4,835
NCDs	1,262	NCDs	2,293
Loans & Advances	132,760	Deposits	130,219
BAs, Bills of Exchange	788		
FRNs & Commercial Paper	571		
Investments	8,273		
Other assets	15,481	Other liabilities	37,629
Subtotal	232,281	Subtotal	240,252
Foreign assets	292,692	Foreign liabilities	285,722
Total Assets	525,973	Total Liabilities	525,973

Note: Data may not add to totals due to rounding.

heading on each side of the balance sheet. The separate data for banks and DTCs can then easily be consolidated into an aggregate consolidated balance sheet for the banking system as a whole, and this is also shown opposite.

1. Notes and coin

Starting at the top with the assets, the tables show the vault cash or till cash held by the two groups of banks. Despite the small size and relative lack of importance generally attached to this item, we believe it to be a fundamentally significant figure in the Hong Kong banking system, particularly in relation to the total quantity of deposits. In recent years the ratio of total deposits (old definition i.e. inc. non-HK\$ deposits) to cash currency held by the banks and DTCs has risen steeply - from 57.4 in December 1978 to 78.6 in June 1981. A similar proportionate increase is likely to have occurred for the ratio of HK\$-denominated deposits to cash. (The June level of this ratio was 63.9.) The reasons behind this are several: the improvement in bank cash management techniques thanks to increased use of computers, greater use of cheques or TT transfers by the public rather than cash payments, and increased use of automatic transfers ("auto-pay") for payment of salaries to employees rather than payments by cash, etc. However the monetary significance of the increase in this ratio is most important; it has meant that the same quantity of cash currency reserves held by the banks has supported a larger and larger quantity of deposits. In other words the deposit multiplier for the system as a whole has been rising.

As we explained in the previous issue of AMM, the only real "reserves" in the Hong Kong system are the Exchange Fund's Certificates of Indebtedness, or the bank notes corresponding to them issued by the note-issuing banks. In the past the Exchange Fund exercised indirect control over the quantity of CIs or notes issued because it set a price for them in terms of foreign currency. Today with the Hong Kong dollar floating and the Exchange Fund in any case accepting Hong Kong dollars in payment for CIs instead of foreign currency the Exchange Fund has effectively abrogated its previous role. Thus whereas in the past the Exchange Fund exercised an indirect influence on the money supply through setting the price of HK\$ notes*, today it exercises no such role.

The link between the money supply and the quantity of CIs or banknotes issued in turn derives from the two ratios which comprise the monetary multiplier - the banks' deposit-to-currency ratio and the public's deposit-to-currency ratio. As these have both risen with better cash management techniques by the banks and with the shift by the public from cash and non-interest bearing deposits to higher yielding deposits, a larger and larger quantity of deposits has been built-up like an

* N.B. not intervening in the foreign exchange market to fix or peg the price of the HK\$, but merely announcing a price at which the Exchange Fund will buy or sell CIs to the note-issuing banks. With deposits convertible to currency, and the banks having a choice between loans and cash the market price of HK\$ would never deviate far from the Exchange Fund's announced price.

inverted pyramid on the cash or reserve base of the system as a whole, fuelling more rapid monetary growth. Thus from December 1978 to June 1981 the money multiplier or the ratio of the money supply (M3 - old definition) to total reserves (notes and coin held by the banks and the non-bank public) has risen from 9.9 to 15.5.

2. Interbank Balances

One feature of the new statistics to be heartily welcomed is the restoration of the interbank balances to the consolidated balance sheet statistics. For no very good reason, it seemed to us, these data were discontinued in April 1975, and only assets held at banks abroad and liabilities to banks abroad were published. Domestic interbank data were simply deleted. A separate table giving statistics for the "money markets" (actually only the interbank and inter DTC balances) was re-introduced early in 1980, but again without distinction between different currencies.

The new data show interbank and inter-DTC balances as well as Negotiable CD balances and obligations, both in HK\$ and in total. Since CDs are all issued by banks and DTCs, and over half of them are held by banks and DTCs these instruments are essentially an extension of the interbank market. Those NCDs (negotiable CDs) not held by banks or DTCs but held by the non-bank public are properly included in the money supply.

3. Claims on Private Sector: (i) Loans and Advances

The new data divide up bank and DTC claims on the private sector into (i) Loans and Advances, (ii) Bankers Acceptances and Bills of Exchange, (iii) Floating Rate Notes and Commercial Paper, (iv) Investments and (v) Other Assets. In addition the compilers have been greatly concerned with whether or not the funds are for use in Hong Kong. The new classification adopts five headings in an attempt to identify the economic impact of loans and advances: (a) loans to finance imports to and exports and re-exports from Hong Kong,

(b) loans to finance third party transactions or merchandising trade i.e. trade between different countries where the goods do not enter Hong Kong at all,

(c) other loans for use in Hong Kong, which would include loans to manufacturers, builders, construction companies, home buyers, etc. which are not already covered by (a) or (b),

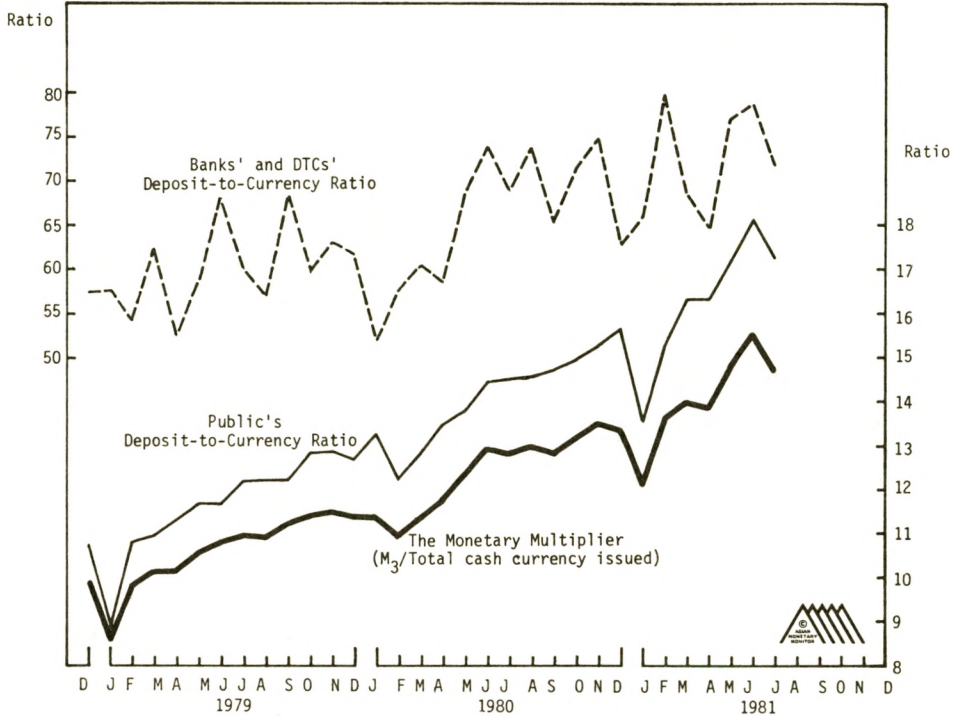
(d) other loans for use outside Hong Kong,

and (e) loans where the place of the use is not known.

Two comments deserve to be made. First it is not clear to us that the new classifications are any more helpful than the

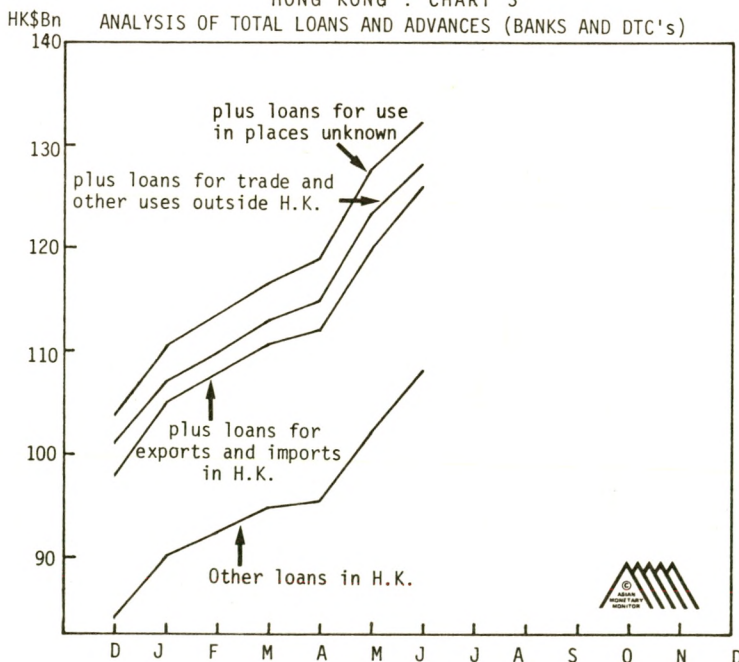
HONG KONG

CHART 2: MONETARY DETERMINANT RATIOS

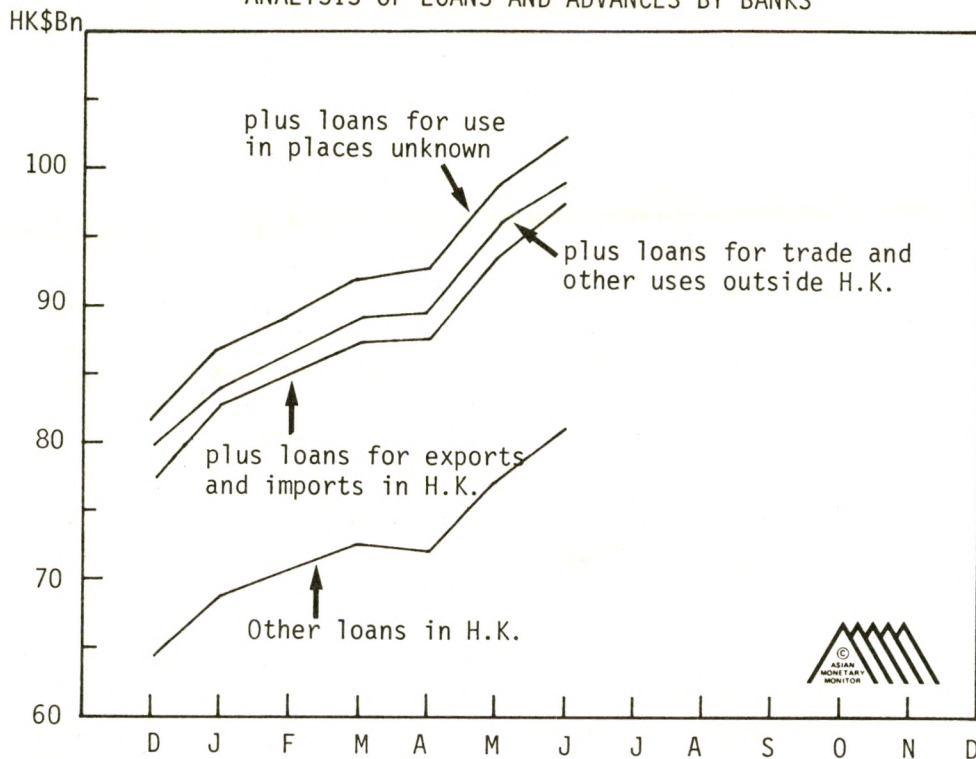


Note: Both the deposit and currency data above include foreign currency denominated items. Properly speaking they should be compiled from HK\$-denominated items only, but as explained in the text, such statistics have only just become available. However the trend (as opposed to the level) of the ratios will only have been distorted if the foreign component of the series has been growing consistently more rapidly than the HK\$ component (or vice-versa). From our studies this seems unlikely.

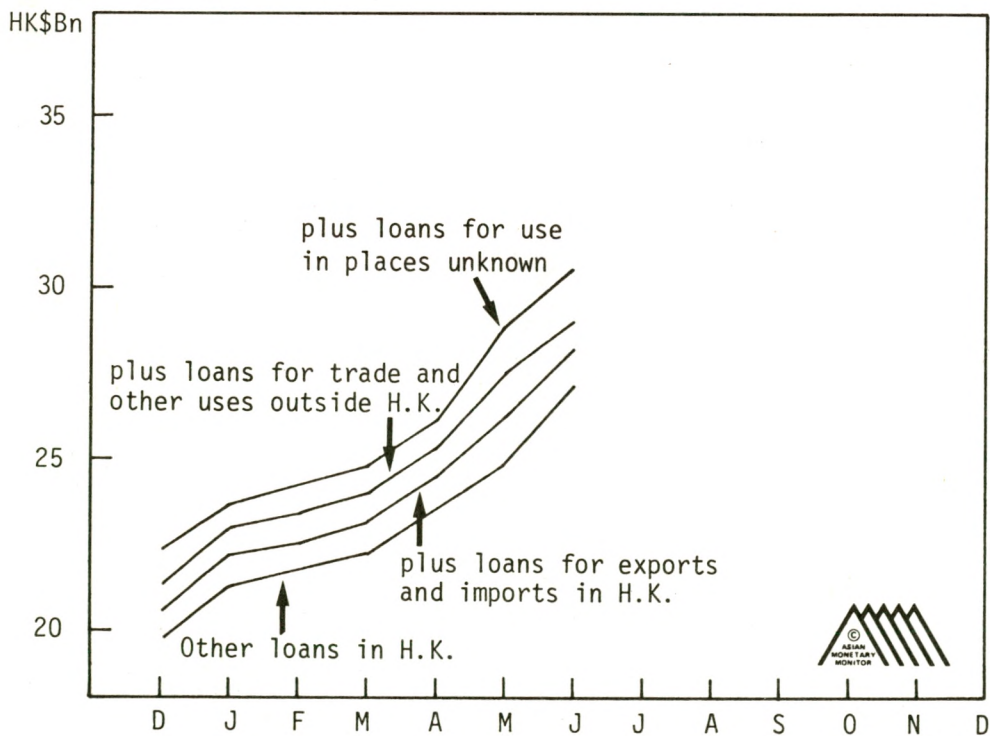
HONG KONG : CHART 3
ANALYSIS OF TOTAL LOANS AND ADVANCES (BANKS AND DTC's)



HONG KONG : CHART 4
ANALYSIS OF LOANS AND ADVANCES BY BANKS



HONG KONG : CHART 5
ANALYSIS OF LOANS AND ADVANCES BY DTC's



old ones. In particular it will not be possible in future, for example, to obtain an indication of the level of activity in the building and construction sector by looking at the rate of loan growth as it was under the old sectoral classifications because the new format does not show the sectoral allocation of funds. Unless there is some official intention to discriminate among these five classes of borrowers by encouraging banks to lend to one category rather than another we can see little benefit in the new breakdown.

Second, if a borrower obtains HK\$ funds for use "outside Hong Kong" either he must sell the funds in the foreign exchange market to pay the foreigner for the goods, services or assets supplied in foreign currency, or, if payment is made in HK\$, the foreigner will at some stage want to sell the HK\$ funds obtained back into the foreign exchange market. In either case the funds end up in Hong Kong, and there is no change in the identity of the individual or entity who has borrowed the Hong Kong dollars. Exports, imports and re-export flows are already satisfactorily reported by the Dept. of Census and Statistics; there seems to be no additional gain in measuring some proportion of these flows which happen to show up at a single point in time on banks' month-end balance sheets.

What is the underlying motive for these new classifications?

We are inclined to think that it springs from a belief among public officials, bankers and some economists that the real cause of inflation is excess credit creation, rather than excess monetary growth. Since banks and DTCs create credit, and it is the credits which will be spent in Hong Kong which are thought to push up prices, these are the ones to be monitored. Then, following the real bills doctrine, since trade credits for imports, exports and re-exports are for 'genuine' needs these are separately identified, while credits for other purposes will presumably be scrutinised more closely.

Insofar as total bank (+DTC) credit approximates to total deposits, and total deposits dominate movements in the money supply, the demerits in this theory will not be too great. However, credits only explain a portion of total expenditures because there is plenty of spending which does not require credit for its financing. Also, if there is any shift in the composition of bank credit (e.g. with more devoted to investments in bonds or equities), the figure for loans and advances could easily show some decline whereas the total of funds available was actually being increased. Finally the money supply is a preferable starting point for a theory explaining total expenditures because deposits and cash currency held by the public are an asset of the public, whereas bank credit is a liability of the public. Monetary theory hypothesises that there is a stable (but not necessarily constant) relationship between the quantity of money assets that individuals and firms own, and the amount of expenditures that they will carry out in any given time period. There is no such well-tested theory for the quantity of credit liabilities of the private sector.

3. Claims on Private Sector: (ii)-(v) Investments, Commercial Paper etc.

The new tables show (ii) Bankers' Acceptances (BAs) and Bills of Exchange, (iii) Floating Rate Notes and Commercial Paper, (iv) Investments and (v) Other Assets.

There is not much to be said about these items, except perhaps to link them to the debate about setting up a central bank in Hong Kong. In terms of size the sum of BAs, Bills of Exchange (\$788 mn.), FRNs and Commercial Paper (\$571 mn.) are at present smaller than the banks' and DTCs' holdings of notes and coin (HK\$1,359 million versus HK\$2,038 million at June 1981 - see Table 1). Nevertheless, if a decision was taken to establish a central bank, these assets would feature prominently among the instruments which the Central Bank or Monetary Authority of Hong Kong would use in any open market operations. In addition the Authority could also deal in any long term bonds which comprise part of the HK\$8,273 million of 'Investments' held by banks and DTCs at the end of June. Assuming a required reserve ratio of 2% (which is similar to the ratios in the U.K. and Japan), that would imply a deposit multiplier of 50 times so that purchases of say HK\$1.5 billion by the Authority would lead to an increase in deposits of up to HK\$75 billion compared with a current HK\$ money supply of HK\$140 billion. In other words, even without the existence of government debt in Hong Kong there is ample scope here for open market operations to be conducted in domestic instruments, leaving aside the possibility of changes in reserves due to purchases and sales of foreign exchange. In short, the new statistics confirm the point made in AMM in March-April 1979 that the lack of government debt is irrelevant to the issue of whether or not a central bank could be established in Hong Kong.

4. Claims on the Public Sector

Under normal IMF reporting conventions public sector borrowings from the banks or bank holdings of government debt are shown separately from claims on the private sector as claims on the public sector. However, the Hong Kong Government runs a persistent budget surplus and therefore has substantial accumulated surplus funds deposited with the banks so it is most unlikely that the Government is a borrower on fiscal account though there are some notional debt instruments issued by the Exchange Fund.* While the omission of 'claims of the public sector' is of no importance in the present context, this may not always be so.**

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* Apart from some working balances the Government has since 1977 transferred to the Exchange Fund responsibility for management of the accumulated budget surpluses. As a counterpart to these funds the Exchange Fund has issued Debt Certificates which are held as an asset by the Treasury.

** There are some public sector debt instruments (e.g. Mass Transit Railway Corporation bonds) held by the private sector. Some of these may well be held by banks since they will qualify as Liquid Assets.

5. Deposits and Other Liabilities

Deposits at banks are collected according to their type (demand/time/savings), but are shown in the consolidated balance sheets as a single aggregate. This is fair enough; the composition of deposits is shown in the separately published table giving the various definitions of money supply. Deposits at DTCs are not classified by type or maturity; a single figure is published and added to M2 deposits to obtain the deposit component of M3. In addition, CDs issued by banks or DTCs and owned by members of the non-bank public are then added to these deposits in arriving at the respective figures for total deposits plus CDs for M2 and M3.

There is one important and outstanding problem with the deposit figures as collected. They still include money balances of the authorities which are not strictly deposits of the non-bank public. Nor is it clear whether the deposits which the authorities hold at short term and which are subject to 100% liquid asset cover, are recorded in the statistics as part of the ordinary deposits total or whether they are recorded in the interbank liability items.

The money supply properly conceived includes the cash currency and deposit liabilities of the banking system held by the non-bank public. As a corrolary it should exclude deposits of the authorities. Until that is done the money supply figures as reported in Hong Kong will remain flawed.

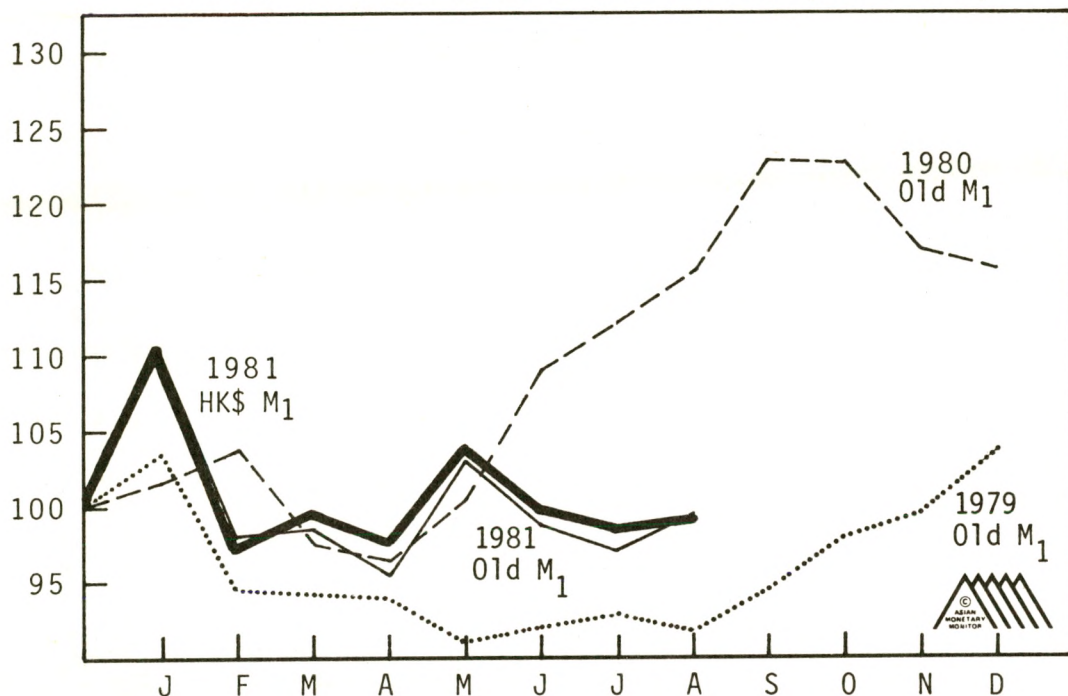
6. Foreign Currency Assets and Liabilities

One of the more satisfactory results of separating out the HK\$-denominated assets and liabilities of the banking system is that for the first time it is possible to calculate the net foreign asset position of the Hong Kong banking system. The first point to note is that if the system runs a net foreign asset position, the counterpart must be a net HK\$ liability position.

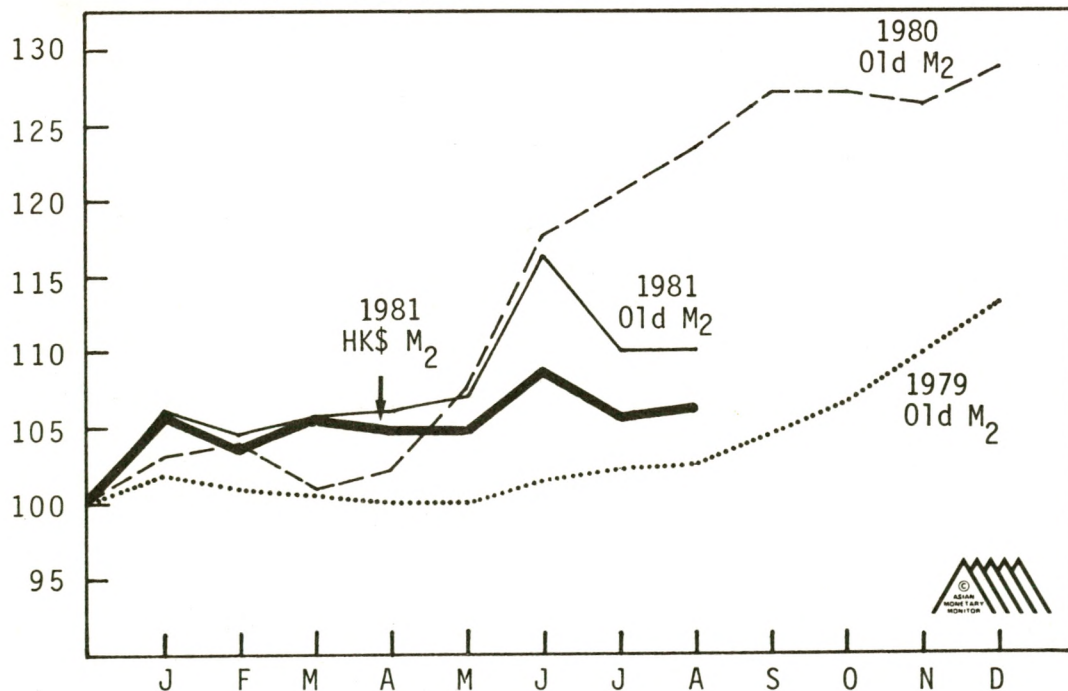
A second point to note is that a major caveat should be issued on the published figures for so-called "inflows" and "outflows". With a floating exchange rate there is no meaningful sense in which these "flows" add to or diminish the money supply in Hong Kong. Even if the exchange rate was pegged and full balance of payments statistics for Hong Kong were collected, the published figures for "inflows" and "outflows" (change in net assets/liabilities to banks and other entities abroad) would still not equal the below-the-line financing item they purport to show unless (a) accounts "in Hong Kong" all related exclusively to residents and accounts "abroad" related exclusively to non-residents, and (b) the change in official reserves was included.

More fundamentally it is illusory to talk of money "flowing in" or "flowing out", except for relatively small amounts of cash currency. For the most part the ownership of HK\$ or foreign currency is exchanged between residents and non-residents; there is no addition to or subtraction from the quantity of money in Hong Kong from the vast majority of such exchange transactions.

HONG KONG : CHART 6
INDEX OF HONG KONG MONEY SUPPLY (Dec.=100)



HONG KONG : CHART 7
INDEX OF HONG KONG MONEY SUPPLY (Dec.=100)



Given these two cautionary notes, the net foreign assets of the banking system have declined from their level in March 1981. This decline might be thought to conform roughly to the pattern of depreciation of the Hong Kong dollar since that time, but there is in fact no such close relationship.

TABLE 2

Licensed Banks			DTCs		HK Banking System	(Month-end data)	
	Net foreign assets	minus	Net foreign Liabilities	equals	Net foreign assets	Trade-Weighted Index of HK\$	HK\$/US\$
1980 Dec	HK\$14,088 mn.		HK\$1,718 mn.		HK\$12,370 mn.	88.2	5.140
1981 Jan	15,333		1,988		13,345	87.6	5.305
Feb	14,668		1,250		13,418	88.5	5.335
Mar	11,842		2,058		9,784	88.8	5.300
Apr	12,905		2,208		10,697	89.2	5.385
May	12,027		2,625		9,402	90.1	5.478
Jun	11,052		4,082		6,970	89.6	5.568

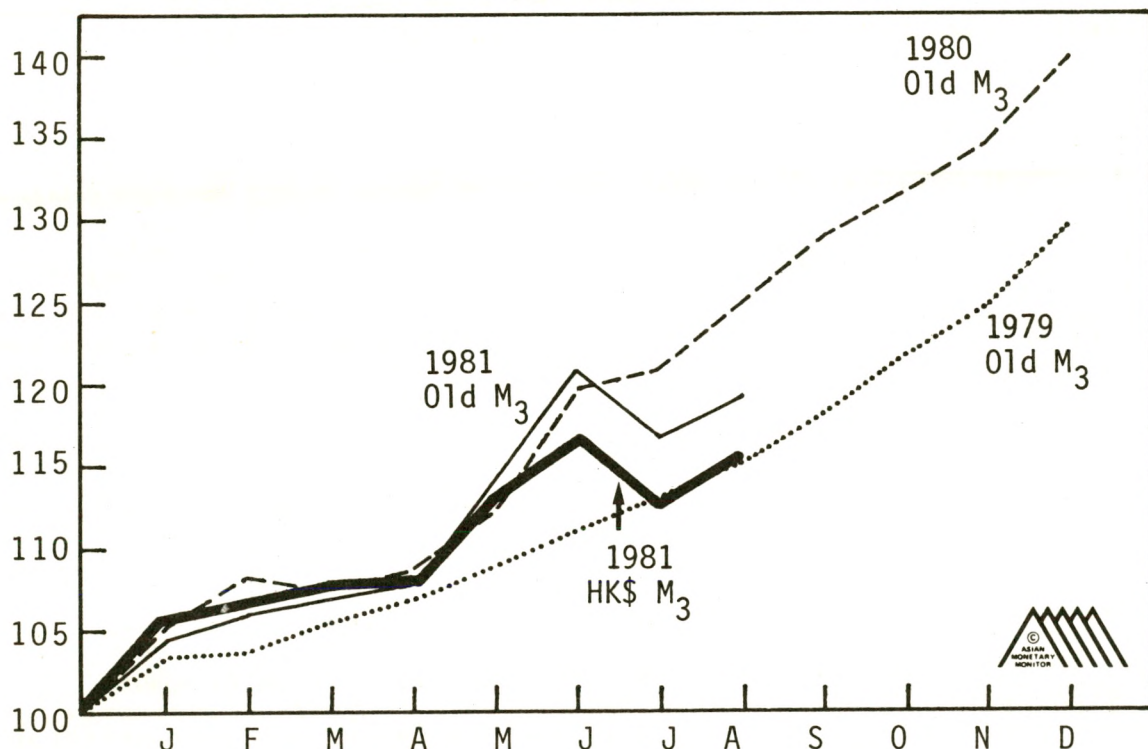
7. Growth Rates of the New Monetary Aggregates

As the new statistics are only available from December 1980 it is not yet possible to make year-to-year comparisons. Since there is considerable variability in the seasonal patterns at year-end (associated with Christmas) and in the early new year (associated with Chinese New Year), the best approach is probably to index each series from December and to compare it with similar indexed series from the preceding years.

It is evident from Charts 6-8 that M1 and M2 have grown more slowly since May 1981 than they did in the period after May 1980, but both are still growing faster (or falling less) than in 1979. This is almost certainly due to the shift of deposits from non-interest bearing demand deposits and low interest-bearing deposits (time and savings deposits) into market-determined interest bearing deposits at DTCs. As a consequence HK\$M3 (which includes these latter deposits) shows a growth rate pretty much unchanged from pattern of the old M3 in 1980 or 1979. Only in July was there any significant deviation - a downturn the Financial Secretary was quick to make use of in his assessment of the economy on September 11th. However, we would be cautious about reading too much into one single month's figures, and we continue to believe that until the fundamental deficiencies of the Hong Kong banking system (explained in detail in the previous issue of AMM) are rectified there is a built-in tendency for monetary growth in Hong Kong to be excessive in relation to the real growth rate of the economy and the level of income velocity.

This does not mean that monetary growth in Hong Kong will not slow down in the months ahead. That was likely to happen for other reasons anyway. The real question is whether the HK\$-denominated money growth rate will remain low enough in the longer term to be compatible with stable prices.

HONG KONG : CHART 8
INDEX OF HONG KONG MONEY SUPPLY (Dec.=100)



CONCLUSION: The new HK\$-denominated monetary statistics are to be welcomed as a further step towards achieving a better understanding of the financial system in Hong Kong. However, there are still several shortcomings:- (1) the failure to separate deposits of the authorities from the total of deposits counted for the money supply; (2) the failure to specify whether deposits of the authorities held at short term and subject to the 100% Liquid Asset cover rule are included in the deposits due to customers or due to other banks, and whether or not they are included in the money supply; (3) the continuing reluctance to disclose changes in net foreign assets of the authorities either as they affect the Hong Kong banking system or in the manner adopted by monetary authorities in all other financial centres as a matter of normal public accountability and as part of the standard balance of payments compilation process; and (4) the dubious value of the new loan classifications.

Because of the 'fungibility' of money or credit the answers submitted by bankers in their monthly returns to the authorities concerning the type of borrower (in the past) or the purpose of the loan (as now required) must inevitably be somewhat arbitrary. Unfortunately the compilers have traded 4 new loan categories by purpose (in local and foreign currency - total 8) for 8 straightforward sectoral loan categories for loans in Hong Kong (with 20 subcategories and 5 sub-subcategories but no currency distinction). We feel the new classifications are more likely to obscure than to clarify 'what's really going on' in Hong Kong, so we think this was a poor trade. It would have been better to have retained the old classifications, consolidated loans in Hong Kong with loans abroad, but subdivided them by currency - local or foreign.

It is in everybody's interest that the mechanics of Hong Kong's financial system as well as the pattern of the aggregate flows are widely understood. We welcome the new statistics, but we would like to see further improvements.

JAPAN

WHY HAS THE CONSUMER SECTOR BEEN SO WEAK ?

By almost any measure activity in the consumer sector of the Japanese economy has suffered severe weakness since the middle of 1980. Initially, many commentators did not view this with very much concern. Nearly all sectors of the economy were undergoing a cyclical contraction as a consequence of the squeeze in monetary growth which commenced in the third quarter of 1979. The impact of the fall in M2+CD growth from 11.4% in September 1979 to 7.4% in January 1981 on mining and manufacturing production, for example, is illustrated in Chart 1.

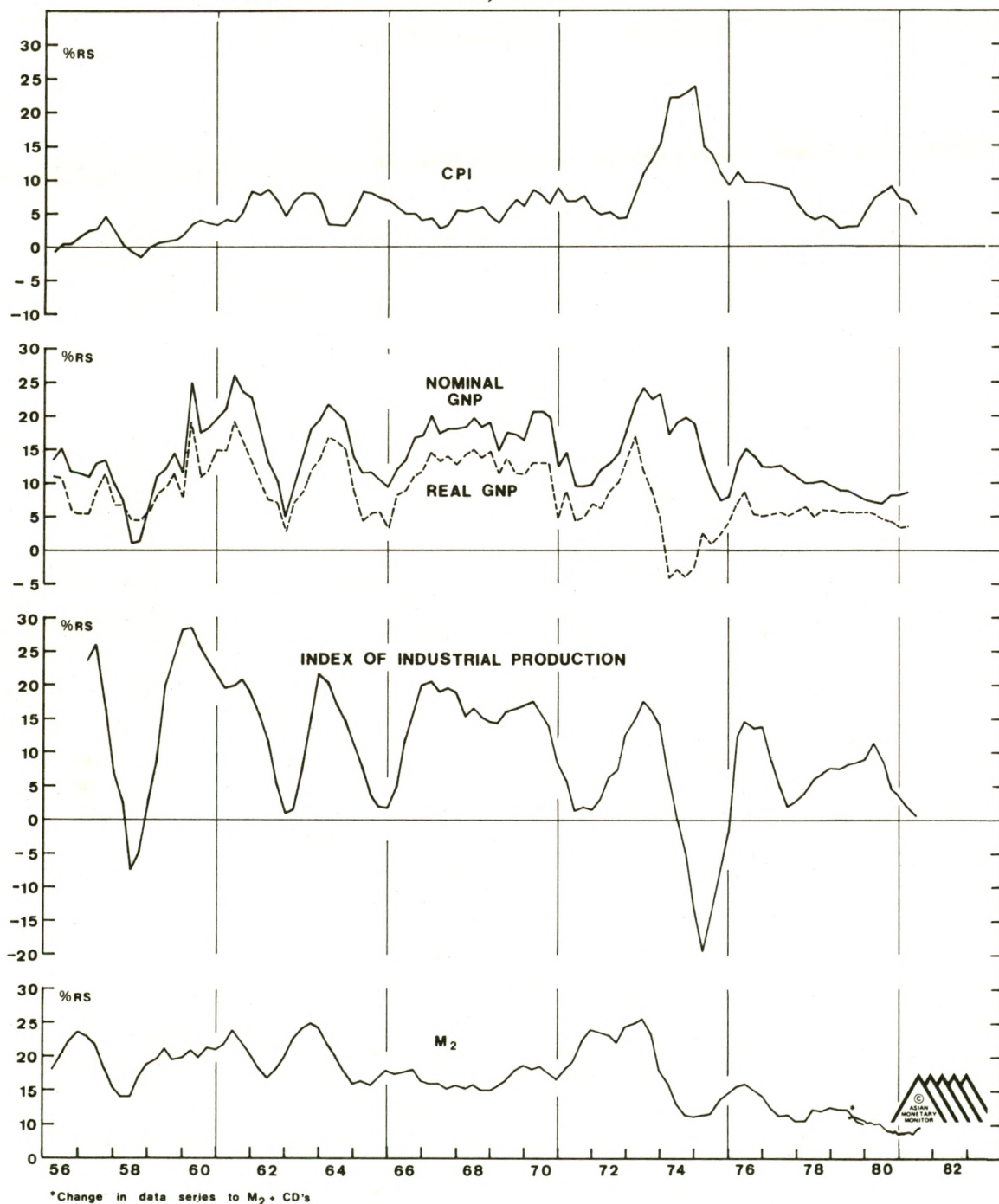
From a cyclically high year-on-year growth rate of nearly 14% in January of last year total output in these industries swiftly levelled off: in May 1981 production had risen a meagre 1% over the previous year. Consumer expenditure was similarly afflicted by the combination of falling monetary growth, relatively high nominal interest rates, and cyclically high levels of consumer price inflation. Moreover, although labour productivity had risen over 12% during 1979, the basic wage agreements formulated early in 1980 did not reflect this. The 6.8% increase in nominal wages negotiated at that time barely kept pace with the average level of consumer price inflation that year. After three years of rising real wages and earnings, and with the rest of the domestic economy entering a cyclical slowdown, it did not appear unreasonable that the consumer sector should also suffer a slowdown in growth.

Chart 2 illustrates the extent of declining activity in Japan's consumer sector. Both sales at Japanese department stores and nominal retail sales growth appear to be suffering a secular decline, but they still follow the basic trend in Japan's business cycle. The decline in the retail sales index has been the most pronounced. The index of retail sales (excluding department store sales) fell 5% in nominal terms in the year to July, and has fallen nearly 10% since February 1980. This probably reflects the drop in Japanese workers' real incomes and real living expenditure implied by the bottom two segments of Chart 2. The rise in housing starts that is depicted in Chart 3 is really the only segment of the Japanese economy associated with the personal sector to exhibit any significant recovery since the start of the year. Even in the housing sector, however, levels of activity remain some 10% below those of last year.

In spite of the cyclical downturn in the rest of the domestic economy, the weakness of Japan's consumer sector has been surprising in at least two important ways. First, the contraction in consumer activity has been relatively more pronounced than in other sectors of the Japanese economy. Chart 4 shows that with the exception of 1974, the decline in real private final consumption expenditure has been more precipitous than any other slowdown during the past two decades. This phenomenon requires careful examination since

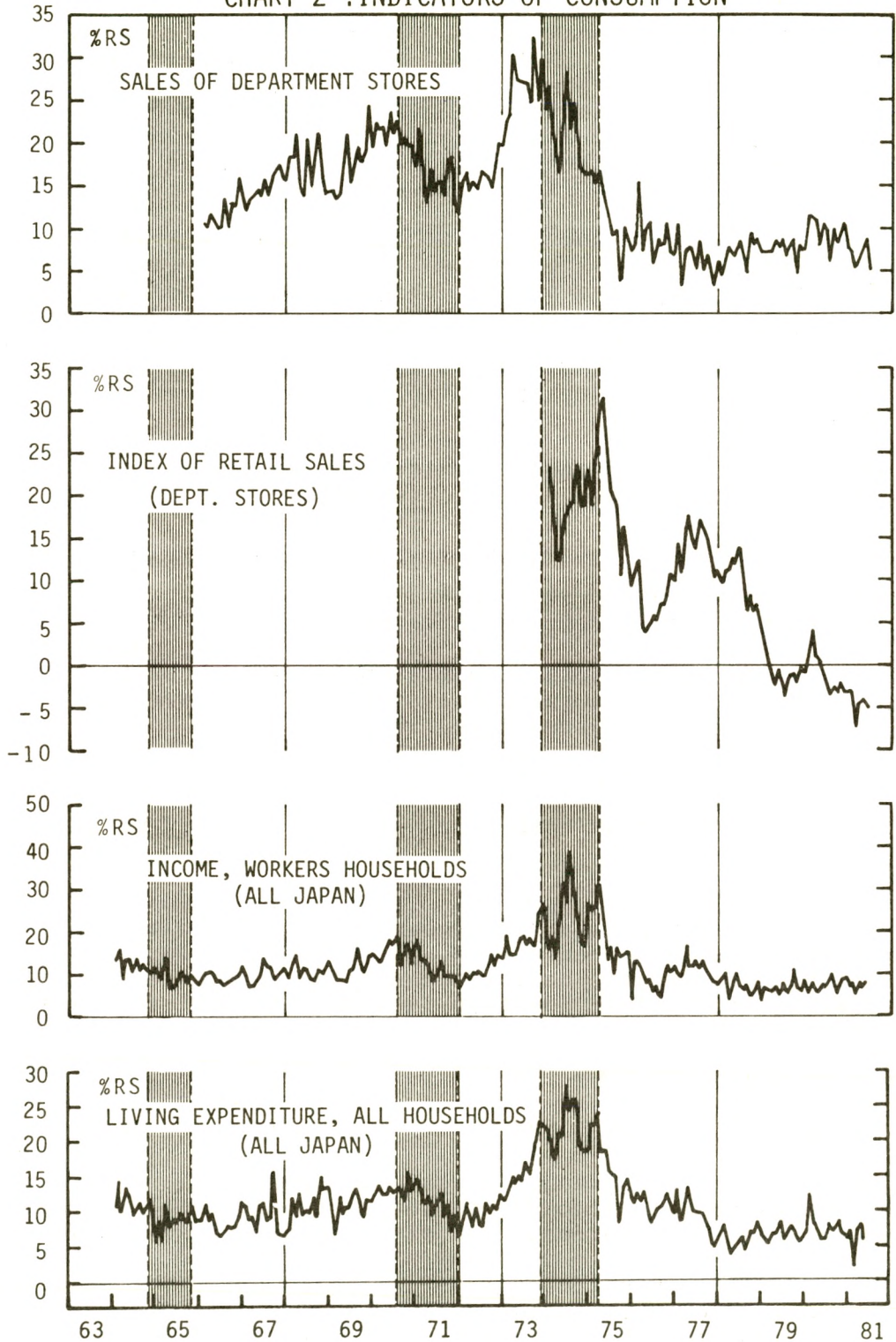
JAPAN

CHART 1 : MONEY, OUTPUT AND PRICES



JAPAN

CHART 2 : INDICATORS OF CONSUMPTION



Source: Japanese Economic Indicators, Economic Planning Agency

there are clearly particularly marked differences between the trend in Japan's business cycle after the first oil crisis and the trend since the 1979 oil price rise. Second, in spite of the sharp decline in the inflation-adjusted level of consumer spending, there are few signs at present of any imminent recovery. By contrast industrial production is now expanding, albeit gradually. After a sluggish performance for much of the first half of this year output in Japan's mining and manufacturing industries rose nearly 5% in the year to August.

In fact, both the sharpness of the decline in real consumer spending and its continued low level are related. They are not a reflection of any structural decay in Japan's consumer sector. Rather, these trends are an excellent illustration of the changed characteristics of business cycles in those economies such as Japan's where the Central Bank has instituted effective monetary control and where there is now a freely floating exchange rate.

One way to demonstrate this view is to outline the following straightforward economic identities:

$$1) C + I + G + X - M \equiv Y \equiv Y_d + T$$

where: C represents private consumption
 I represents private investment
 G represents government consumption or spending
 X represents total exports of goods and services
 M represents total imports of goods and services
 Y represents Gross Domestic Expenditure
 Y_d represents disposable private income
 T represents government's tax revenues

If we subtract T from both sides of this identity we derive:

$$2) C + I + (G - T) + X - M \equiv Y_d$$

The term (G-T) represents the government's deficit or surplus in any given period. If we assume, for simplicity, that the government's deficit or surplus remains constant and write this second identity in terms of absolute changes we derive:

$$3) \Delta C + \Delta I + \Delta X - \Delta M \equiv \Delta Y_d$$

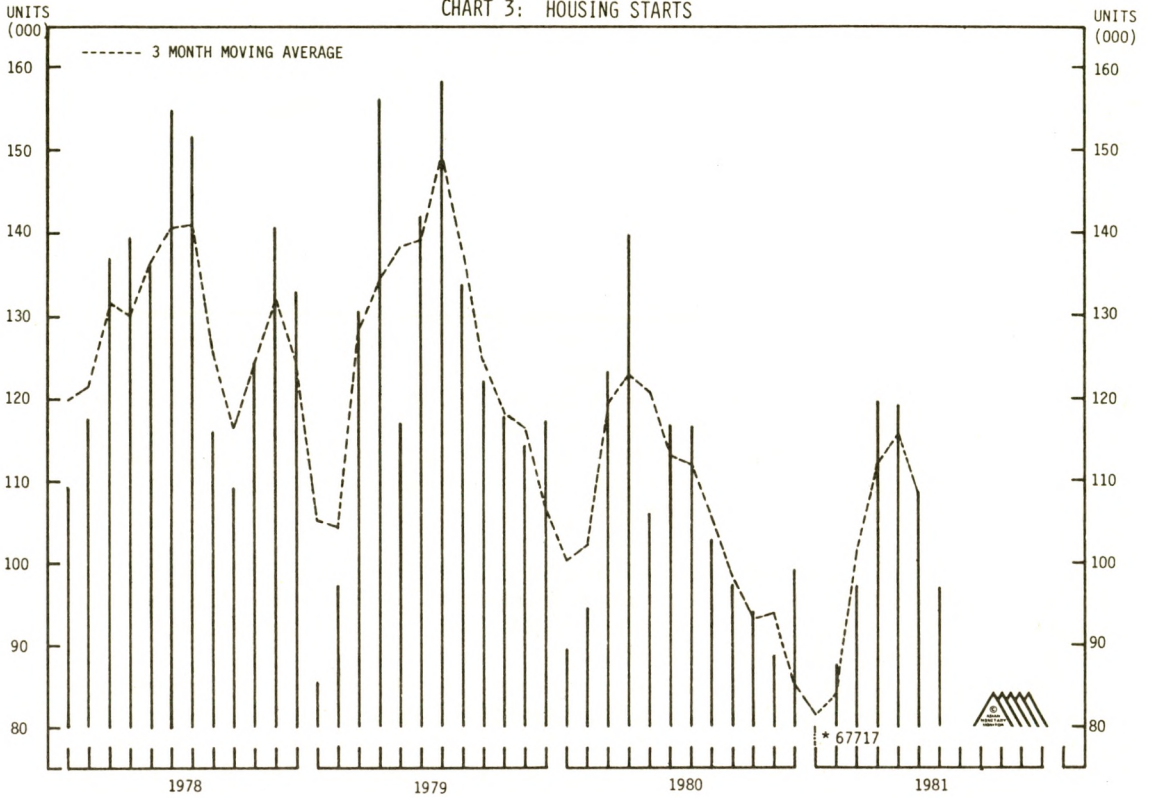
or

$$4) \Delta C \equiv \Delta Y_d - \Delta I - (\Delta X - \Delta M)$$

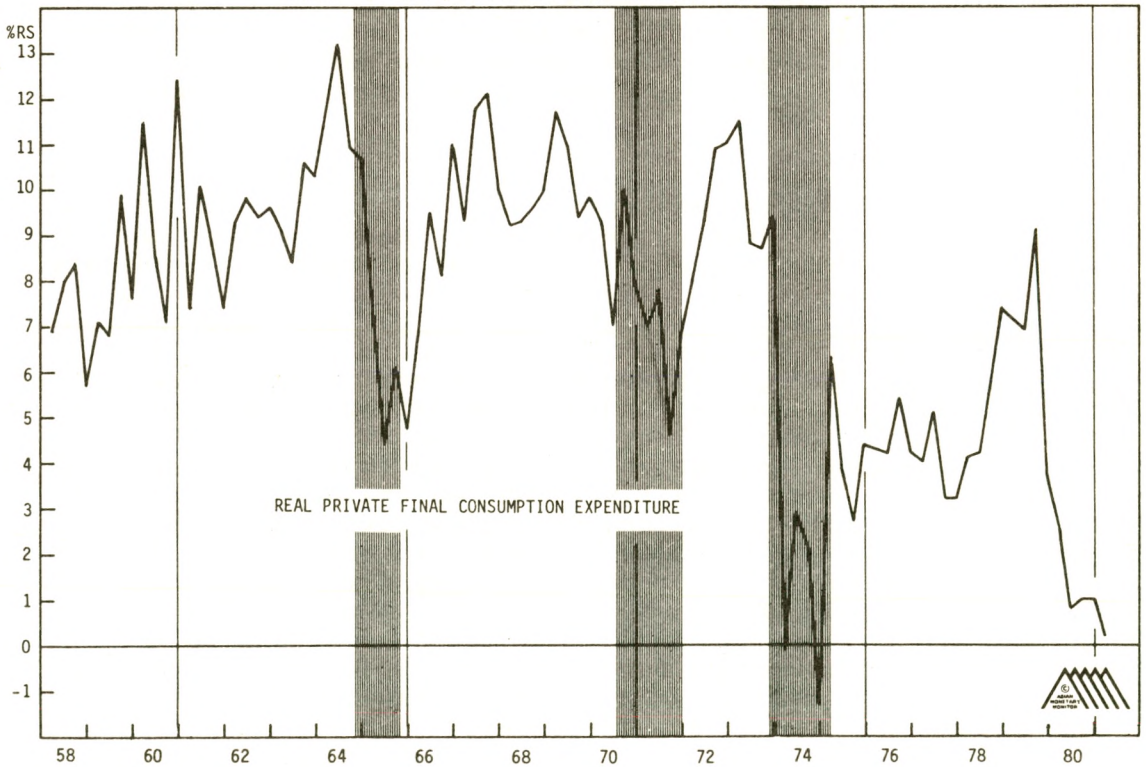
Or in words, the change in consumer spending is equal to changes in disposable income less the change in total private investment minus the net position of the external sector.

As it stands this fourth identity tells us very little. It is simply an economic axiom derived exclusively from the assumptions set out above. This identity relates changes in the level of activity in one sector of the economy to changes in another, but says nothing about the influences behind these adjustments. However if we can identify the basis for cyclical

JAPAN
CHART 3: HOUSING STARTS



JAPAN
CHART 4: REAL PRIVATE FINAL CONSUMPTION EXPENDITURE



movements in key variables such as national income* and the trade balance, then identity (4) becomes a useful analytical expression. Therefore we must develop a theory to explain the behaviour of income, the trade balance and consumption in relation to Japan's monetary and exchange rate policy. In particular, we want to examine some of the implications of the switch in monetary policy that occurred in July 1974.

Prior to that date, as we have discussed in many previous editions of Asian Monetary Monitor, the rate of growth of Japan's money supply was determined indirectly. The Bank of Japan bought foreign exchange (when there was an external surplus) or sold foreign exchange (in the case of a cyclical external deficit) in order to maintain the yen at a fixed rate to the US dollar. Monetary growth was thus highly cyclical, dependent on the trend in Japan's external account, and was reflected in pronounced cyclical movements in production, nominal GNP growth, and inflation.

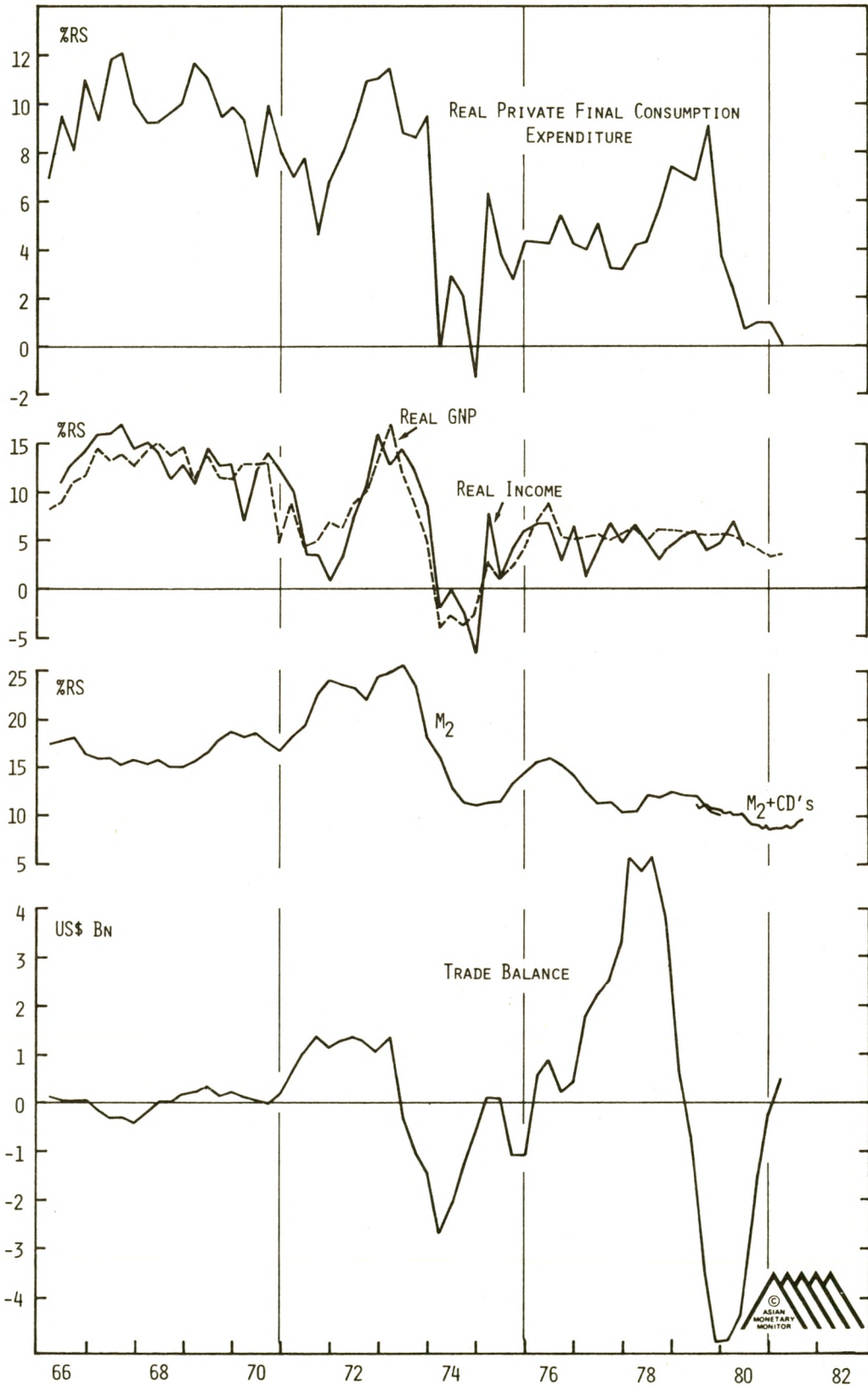
This has important implications for identity (4) since it implies that changes in personal disposable income (Y_d) and changes in the external sector ($X-M$) are linked by another variable, namely changes in monetary growth. Thus in Japanese business cycles up until 1974 changes in the level of domestic consumption were basically determined by changes in disposable private income. Disposable private income was in turn broadly determined by changes in monetary growth and ultimately by the trend in the external account.

These relationships are evident in Chart 5. It is clear that in each business cycle up until 1975, consumer spending was pro-cyclical. In other words, activity in the consumer sector rose during the upswing in the business cycle and then declined as the external account moved into deficit, monetary growth contracted, and all sectors of the economy suffered a simultaneous slowdown.

The 1972-75 period is a good example of Japan's consumption cycle whilst the economy was operating under a fixed exchange rate. During 1972, Japan experienced a healthy balance of trade surplus. This contributed to an acceleration in monetary growth and M2 rose more than 20% over the course of the year. Consumer price inflation at that time was falling, averaged no more than 5% during the year. Hence domestic liquidity was very easy. Real GNP growth and real national income growth were naturally very buoyant under these circumstances, and the cyclical boom was also reflected in strong rises in real consumption expenditure, which rose 11% in 1972. A relatively firm level of consumption activity was maintained throughout 1973. Monetary growth remained at a high level and inflation, though rising, was still below its ultimate peak level. However, the foundations for the forthcoming recession were already being laid. There was a noticeable decline in Japan's trade surplus as imports surged - partly in response to the rise in consumption expenditure. During 1974, Japan's balance of trade position slipped sharply into deficit. This led to a sizeable decline in monetary growth and, with consumer price

* Disposable income is defined as national income less direct taxes.

JAPAN
 CHART 5: THE DETERMINANTS OF REAL CONSUMPTION



inflation rising well over 20%, a severe squeeze on nominal incomes and a sharp rise in interest rates. Real consumption expenditure plummeted as real GDP contracted. The simultaneous advance, and subsequent decline, of the trade account, monetary growth, real incomes and consumption was a typical example of an economy operating with a fixed exchange rate.

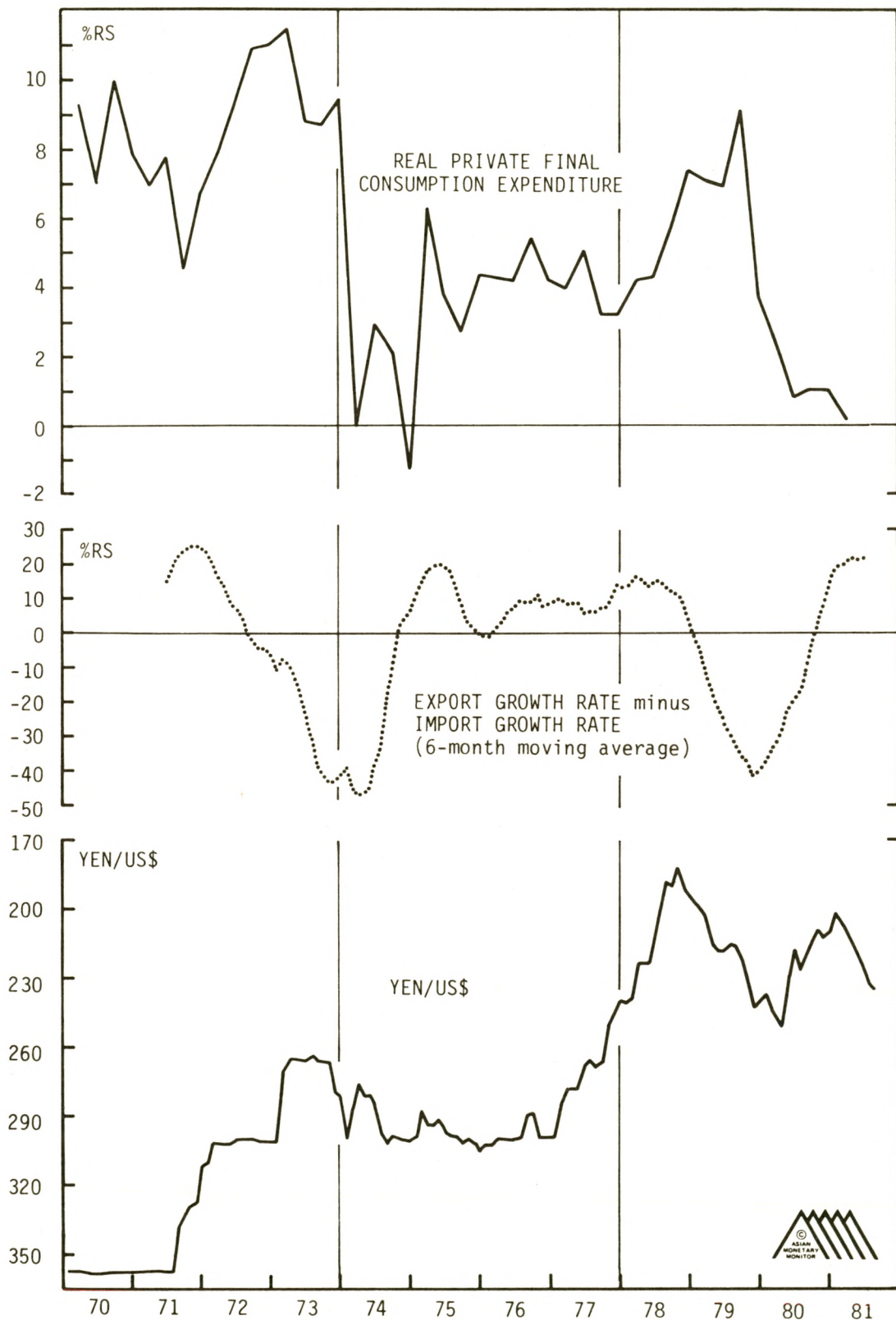
One important consequence of the Bank of Japan's 1974 decision to control monetary growth directly whilst allowing the yen to float freely on the foreign exchanges has been that Japanese monetary growth is now broadly independent of trends in Japan's external account. This implies, in terms of identity (4), that disposable income is now much more independent of monetary growth than was the case before 1975. If we could assume that the Bank of Japan managed monetary policy to ensure that the rate of growth of national income was reasonably unchanged, then identity (4) implies that the cyclical level of consumption in Japan is inversely related to the cyclical position of the external account (providing investment and the government's budgetary position is unchanged). This is exactly the reverse of the position under the fixed exchange rate regime, where consumer spending moved in line with changes in the external account.

Chart 5 shows that the trends in real national income and the real GNP have moved quite closely during the last two decades. Unfortunately the real national income statistics are not yet available for the period since June 1980, but it seems reasonable to assume that real national income has fallen slightly along with real GNP during the last twelve months. The decline in real national income will in itself have been responsible for part of the fall in consumer activity in Japan, but it does not explain the severity of the decline or the failure of real private final consumption expenditure to recover along with the gradual upturn in the rest of the domestic economy. These last two phenomena are best explained by the reallocation of resources in Japan towards exports; with exports growing some 20% faster than imports, the consumer sector in Japan must be at a cyclically low ebb. This is a predictable consequence of the characteristics of Japan's business cycle: adjustments to changes in the overall competitiveness of the economy are brought about through shifts in particular sectors of the economy in response to relative price changes rather than through a simultaneous expansion of all sectors in the economy as a consequence of changes in GNP.

This process, and its notable contrast with the period before 1975, is vividly illustrated in Charts 5 and 6. In 1974 the cyclical contraction in real consumer spending occurred simultaneously with both an external deficit and a deep recession in the domestic economy. But in 1980 an equally sharp downturn in real consumer spending occurred whilst Japan's external sector was improving rapidly and without an absolute decline in real GNP.

JAPAN: CHART 6

THE YEN RATE, TREND IN THE TRADE BALANCE AND REAL CONSUMPTION

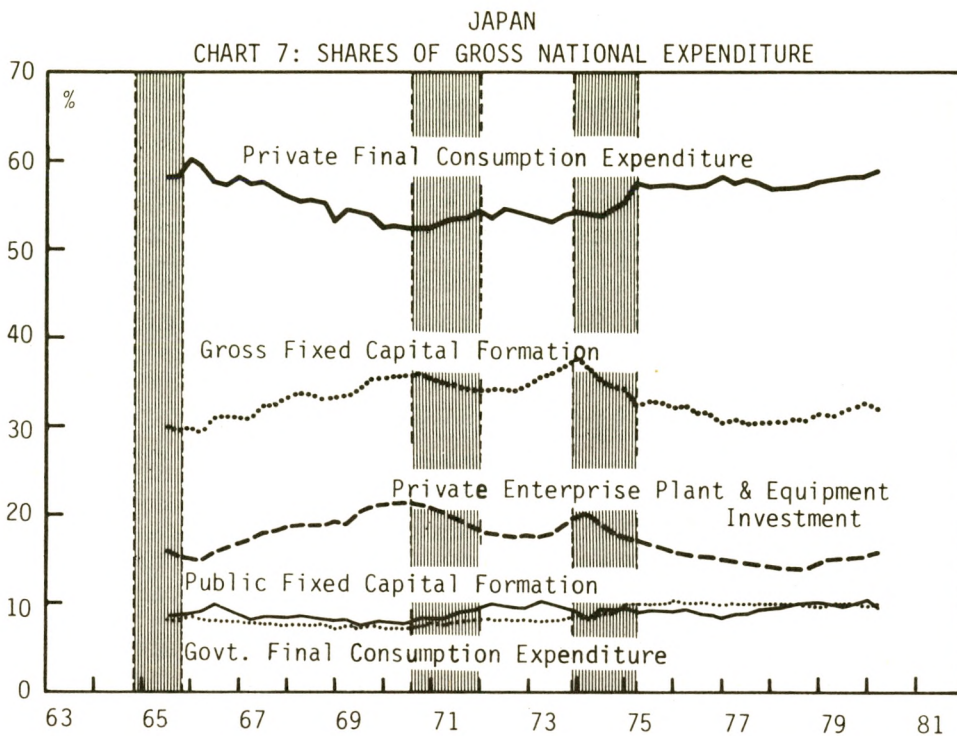


Primarily as a result of the 300% rise in OPEC oil prices during 1979 Japan's overall terms of trade plummeted over 35% from the end of 1978 to March 1980. In the absence of a corresponding rise in Japanese export prices the increase in oil prices represents a once and for all decline in Japan's real purchasing power. However overall GNP growth can be maintained if economic resources are shifted away from domestic consumption (of goods either produced in Japan, or imported) and transferred to the export sector. This is what has occurred in Japan during the past two years. This sectoral adjustment has been generated by very large changes in the price of the yen. Japanese exports became relatively cheaper as the yen weakened, whilst imports became more expensive relative to domestically produced goods. The external sector moved back into surplus, and the corresponding adjustment in the domestic economy has been a cyclical weakness in private consumption.

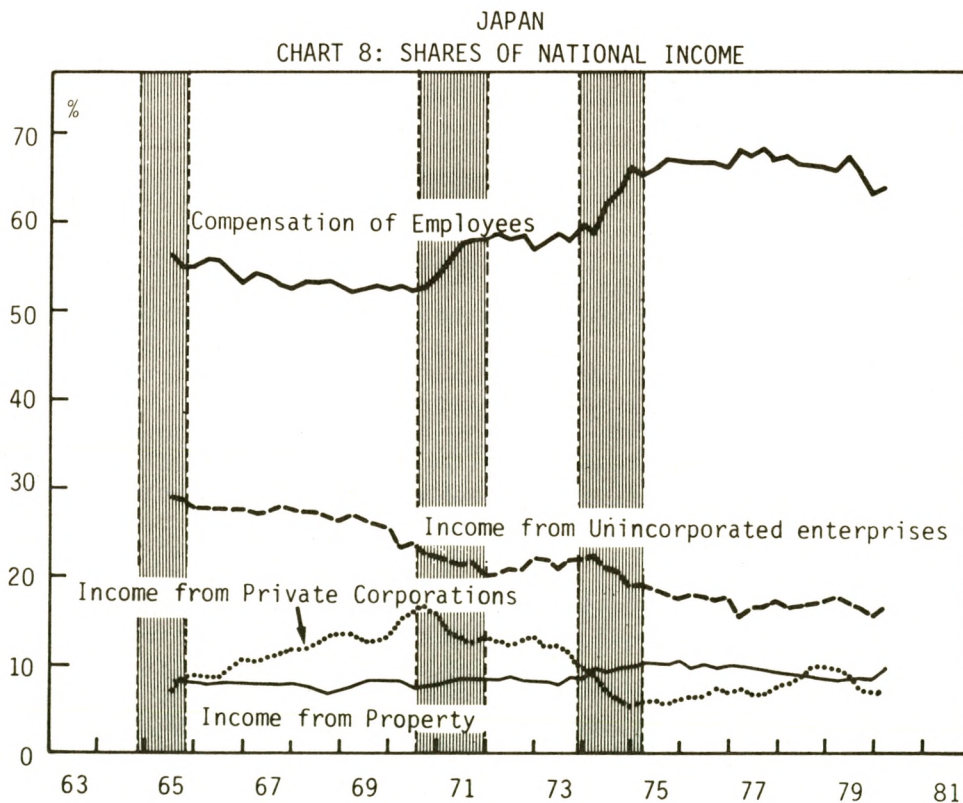
FORECAST: Domestic consumption in Japan has been hard hit by a combination of three factors. First, it has suffered, along with many other sectors in the domestic economy, from the cyclical downturn in Japan's real growth. Second, and more importantly, however, domestic consumption has contracted as a result of Japan's need to adjust to external circumstances and the impact these have had on Japan's trade balance. The weakness of the yen during 1979 provided the incentive to shift resources away from domestic consumption towards exports. Third, this incentive was maintained in 1980 as a consequence of the slowdown in Japan's economic growth. With export growth exceeding import growth by more than 20%, the government's budget deficit relatively unchanged, and private investment firm, it has been almost inevitable that private consumption should weaken. This is implied by the relationships in identity (4), and by the behavioural links (which are determined by the Bank of Japan's changed monetary policy) that are demonstrated in Charts 5 and 6.

The thesis is straightforward. The Bank of Japan maintains monetary growth at a stable, moderate level. This generates relatively steady rates of real economic growth. As a consequence, real GNP and real national incomes have grown relatively steadily. Thus the process of economic adjustment (to events such as the 1979 OPEC price increase or, more recently, the unusual strength of the US dollar) occurs though cyclical changes in the sectoral composition of GNP. Over the last eighteen months Japan has experienced a cyclical rise in its exports sector as a result of a relatively undervalued yen, a rise in investment spending, and a correspondingly weak consumer sector.

These trends are cyclical. Japanese domestic consumption will begin to recover as overall GNP and national income continue their gradual upturn following the Bank of Japan's decision to allow moderately faster monetary growth this year. However any significant improvement in the consumer sector must await a downturn in export growth relative to import growth. This will be associated with the next period of cyclical strength in the yen.



Source: Japanese Economic Indicators, Economic Planning Agency



Source: Japanese Economic Indicators, Economic Planning Agency

THAILAND

DEVALUATION - AND NOW MONETARY RESTRAINT ?

July 15 of this year saw the Thai Baht devalued by 8.7% against the dollar, the parity being changed from 21.0 baht to the dollar to 23.0. This represented a significant and controversial change of policy by the Bank of Thailand, which had denied the possibility of a devaluation only two months previously, although it came as no surprise to observers in view of Thailand's rapidly deteriorating trade imbalance and the deepening economic crisis in which it found itself. The devaluation immediately sparked off speculation that further devaluations could follow in the future if Thailand's economic performance showed no signs of improving. Yet in the first half of the 1970s, Thailand's economy was relatively healthy and backed up by a strong currency. Where is it that the management of the Thai economy has gone wrong?

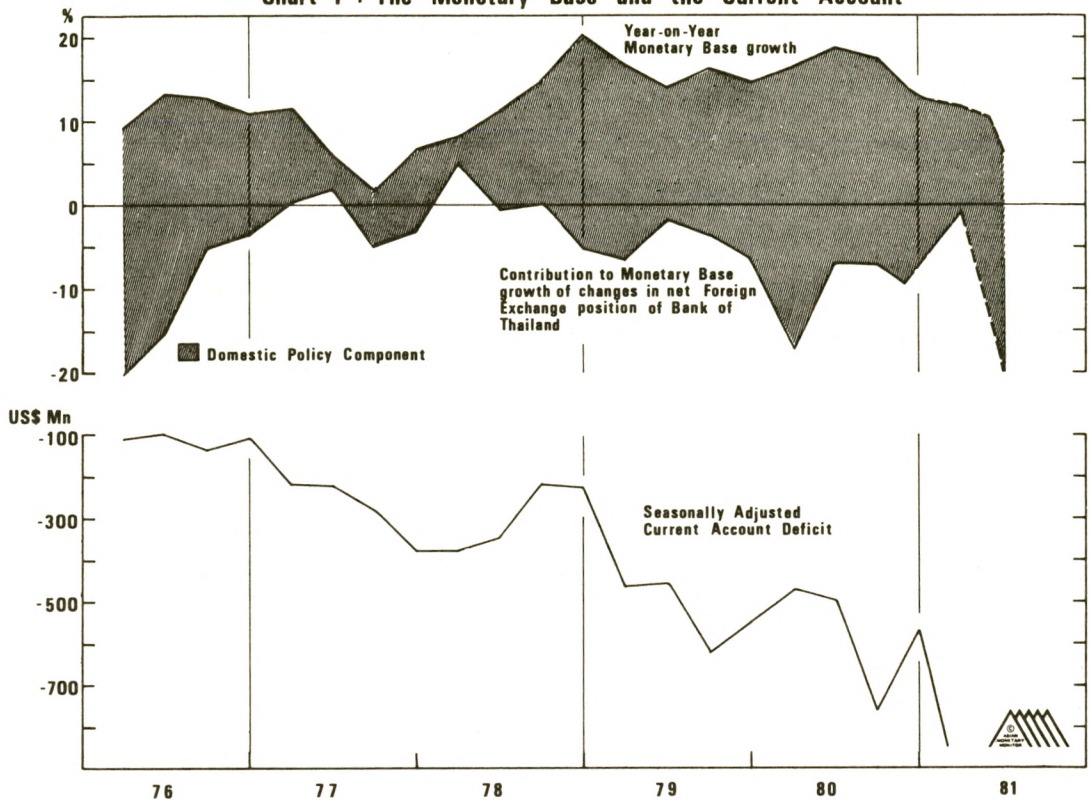
For 15 years up to March 1978 the baht was pegged to the US dollar, since when it has been unpegged, and managed against a basket of currencies in which the US dollar has been by far the most important component. Restrained macro-economic policies in the 1960s, without large budget deficits to finance enabled the Bank of Thailand to retain monetary control and the balance of payments remained strong. However, the latter half of the 1970s has seen accelerating monetary growth, very high rates of consumer price inflation, and a rapidly deteriorating balance of payments position.

It is true that external economic factors have been unfavourable - the oil price shock of 1979 had a severe effect on Thailand which is a large oil importer, and the strength of the US dollar this year made some devaluation of the baht vis-a-vis the dollar more likely as the pegging to the dollar meant that the baht had appreciated over 14% against the Deutschemark, 11% against the pound and 4½% against the yen in the first 5 months of this year. A 1.08% depreciation against the dollar in May could not fully adjust for this growing loss of competitiveness in European and Japanese markets. However, external factors alone can nowhere near fully account for the baht's weakness. How is it that the combination of rapid monetary growth, high inflation and a rapidly deteriorating current balance has been compatible in the long-term in a fixed exchange rate economy?

The classic fixed rate adjustment mechanism would suggest that persistent balance of payments deficits would be matched by a drain on domestic liquidity as commercial banks made purchases of foreign currency from the central bank (leading to a decline in net foreign assets held by the central bank). Their reserve accounts with the central bank, which form one important component of the monetary base, would be simultaneously debited. The subsequent slowdown in monetary growth and hence lower level of activity in the economy should lead to an

THAILAND

Chart 1 : The Monetary Base and the Current Account



improvement in the external account. In Thailand's case, this singularly failed to happen in the second half of the last decade.

Chart 1 illustrates the relationship between the deficit on the current account of the balance of payments (seasonally adjusted by means of a modified moving average method), the year-on-year growth in the monetary base and the contribution to this growth that has been made by changes in the net foreign asset position of the Bank of Thailand since 1976. It can be seen that the contribution of changes in net foreign assets at the central bank to monetary growth in most quarters is negative, indicating that the monetary base would have declined as the result of balance of payments deficits had the Bank of Thailand not taken offsetting action. However, monetary base growth in fact accelerated throughout much of this period as a result of increases in the size of the domestic policy component of monetary base growth i.e. The Bank of Thailand more than made up for any drain on the reserves of the commercial banks by either loaning funds to them directly or buying government debt from them. Hence, the monetary base has been allowed to expand rapidly despite persistent current account deficits.

THAILAND : CHART 2

The Balance of Payments and the Bank of Thailand's Net Foreign Asset Position

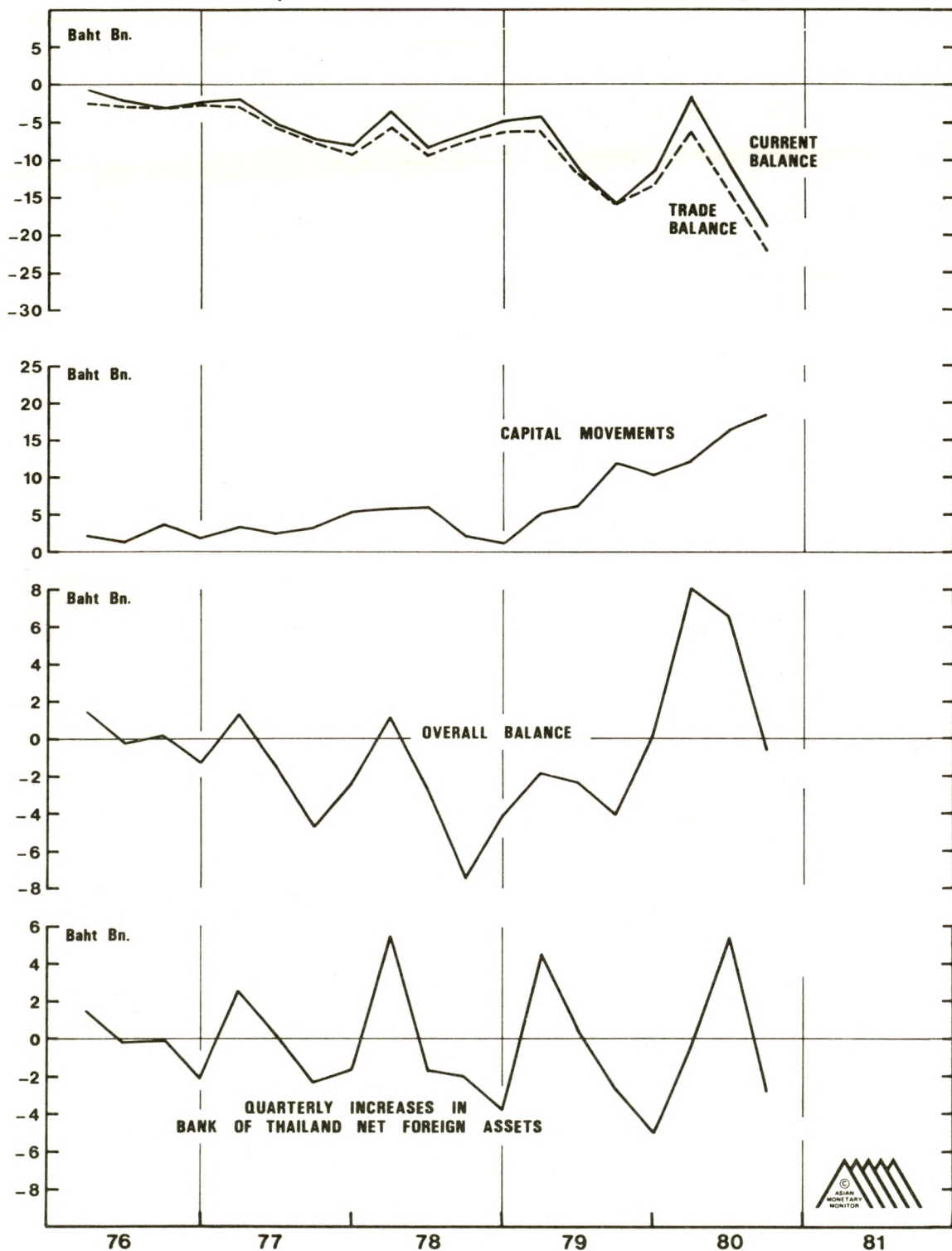


Chart 2 illustrates the relationship between the two main components of the overall balance of payments (or balance to be financed) - i.e. the current account and the capital account - the overall balance itself, and the quarterly increases in the net foreign assets of the Bank of Thailand. Any deficit on the overall balance must be financed either by a decrease in the net foreign assets of government institutions or by a decrease in the net foreign assets of private institutions. It can be seen that there has been an upward trend in capital inflows, particularly noticeable since 1979. These inflows comprise mainly overseas borrowings by government and private institutions and hence represent an increase in private and non-central bank government institutions' liabilities.

The trend in the capital account (and hence the private institutions' net foreign asset position) has been roughly stable and hence there is a close relationship observable between short term fluctuations (mainly seasonal) in the overall balance and the increase in the net foreign asset position of the Bank of Thailand. Discrepancies between movements in the current account deficit and movements in the net foreign asset position of the Bank of Thailand (for instance from 1976 to 1978 and in the first quarter of 1980) noticeable on Chart 1 can then be easily explained by movements in the capital account, or in particular the borrowing behaviour of commercial banks. For example, from 1976 to 1978 when a deteriorating current account deficit was accompanied by increased net foreign assets at the central bank (when measured on a year-on-year basis), commercial banks' borrowing from abroad increased from 8,051.5 million baht to 24,804.8 million baht. In other words capital inflows offset the current account deficit sufficiently for the overall balance to show a surplus in some quarters. Conversely, in the first quarter of 1980 when an improved trade position was accompanied by a deteriorating central bank net foreign asset position the reason was that commercial banks were repaying their borrowings from abroad which declined from 35,421.7 million baht to 27,055.4 million baht by the end of the quarter. Thus, capital outflows offset the considerable trade improvement to such an extent that the overall balance did not show its usual seasonal surplus.

Thus, briefly, there are two factors which have caused a deteriorating trade position not to be reflected in a contraction in monetary base growth. The first is heavy overseas borrowing to finance the deficits, and the second is operations by the Bank of Thailand to offset any effects deficits might have had on the monetary base.

Given the rapid expansion of the monetary base made possible by the Bank of Thailand, it is hardly surprising that consumer price inflation has reached such high levels (20% in 1980) and the external balance has deteriorated so rapidly. As has been discussed in previous issues of AMM there was a squeeze on M2 in 1979, but this proved only to be temporary and M2 growth took off more rapidly than ever before during 1980, accelerating from 13.9% year-on-year in the last quarter of 1979 to 22.6% by the end of 1980. Although Thailand has a

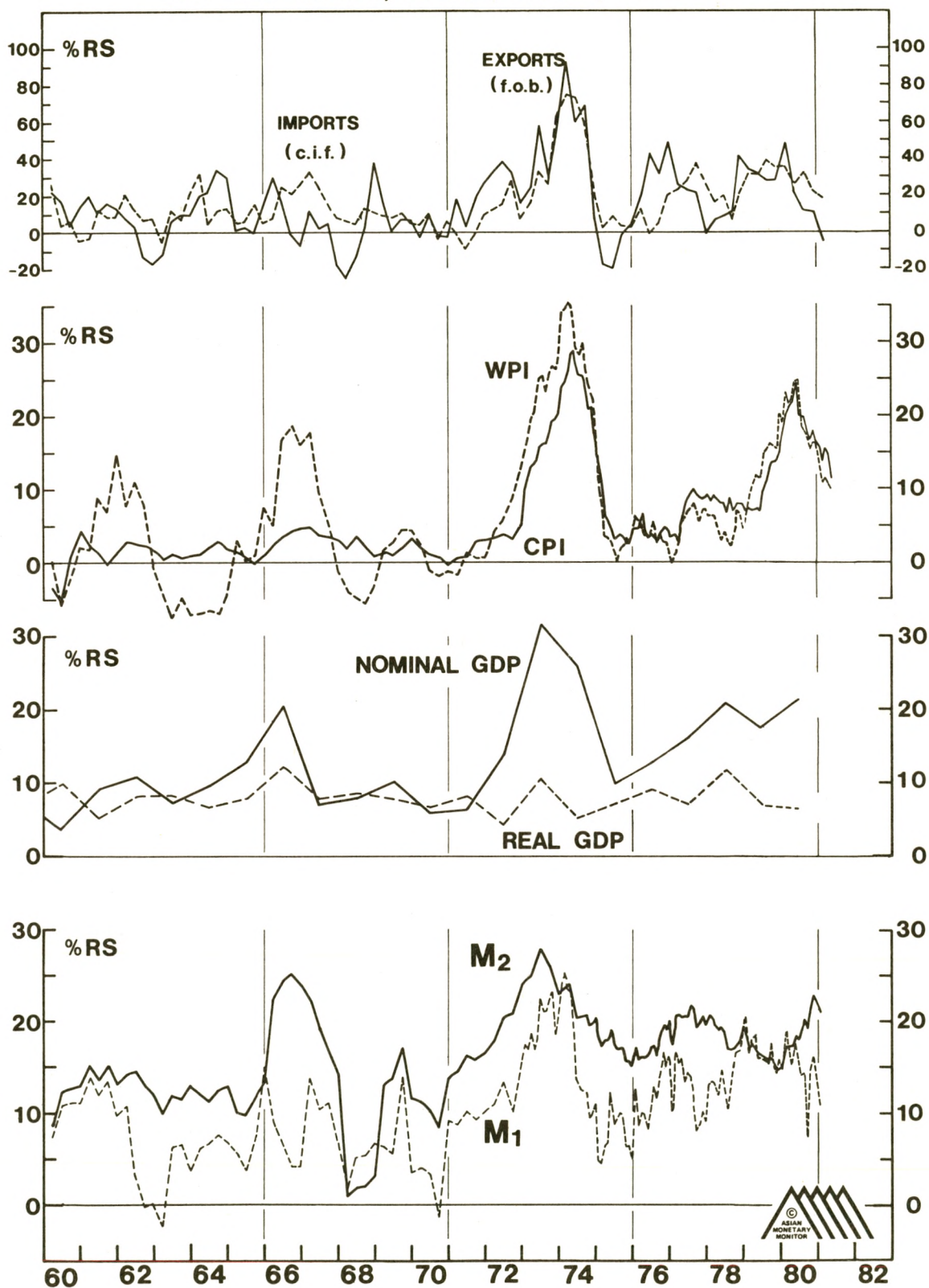
relatively high rate of real G.D.P. growth, this is a rate of monetary growth far in excess of anything that could be consistent with stable prices in the longer term. Therefore, why did the Bank of Thailand not allow the slowdown in monetary growth that occurred in 1979 to continue, thereby easing inflationary pressures on the economy?

Although M2 was squeezed in 1979 from a year-on-year rate of growth of 19.1% in the final quarter of 1978 to 13.9% at the end of 1979 (see Chart 3), the growth of the monetary base showed no such trend. Throughout 1979, the year-on-year rate of growth dropped only two percentage points during the year. Although this divergence between monetary base and money supply growth can be partly explained by high rates of inflation in 1979 and hence an increase in notes and coin in circulation, there are two possible basic factors at the root of the discrepancy:

- (1) There is a very marked seasonal pattern to the growth of the monetary base, with the base always reaching its highest levels in the first and fourth quarters of any year due to the agricultural crops coming to the market in these quarters. Thus, notes and coin in circulation are increased in these quarters, and also, as exports are at their highest level, the net foreign asset position of the Bank of Thailand grows most rapidly. However, until 1978 this seasonal pattern in monetary base growth failed to be reflected to any notable extent in M2, as commercial banks held relatively large reserves against private sector deposit liabilities and maintained excess reserves in the 4th and 1st quarters of each year, running them down to the third quarter when activity and exports are lowest. But the ratio of reserves held against total private sector deposit liabilities in the banking system showed a marked downward trend in the second half of the 1970s and thus there became less scope for this seasonal variation of the ratio as the decade progressed. Thus, seasonal fluctuations in the monetary base became increasingly reflected in fluctuations in M2 towards the end of the 1970s, and so statistically in 1979 we could have expected some reduction in M2 growth when measured on a year-on-year basis.
- (2) However, in 1979, this basically statistical phenomenon was probably overshadowed by the effects of the Bank of Thailand's policy of maintaining artificially low interest rates - a policy designed to encourage investment and economic growth. At the low rates prevailing in 1979 the demand for credit far exceeded the supply of deposits to the commercial banks and there was also probably a reduction in the public's deposit-to-currency ratio (i.e. the public chose to hold more of their assets in the form of currency as interest rates were not high enough to overcome the loss of liquidity involved in deposits) and hence a reduction in the money multiplier.

THAILAND

CHART 3 : MONEY, OUTPUT, PRICES, AND TRADE



Therefore it can be seen, as has been discussed in a previous issue of AMM (Vol. 4 No. 2), that the squeeze of 1979 was not engineered by the Bank of Thailand, but was merely a pause in the trend of rapidly expanding monetary growth. It was not therefore surprising that with high rates of growth of the monetary base maintained throughout, M2 growth took off again in 1980.

Against this background, what are the prospects for the early 1980s? Will the devaluation help to restore Thailand's export competitiveness and make possible a surge of export-led growth which will restore the current account to balance, and, with a low level of monetary growth, encourage a high level of GNP growth and low inflation? Or will excessive monetary growth quickly destroy any advantage that may have been gained, making necessary further devaluations which only help to add fuel to inflation through rising import costs?

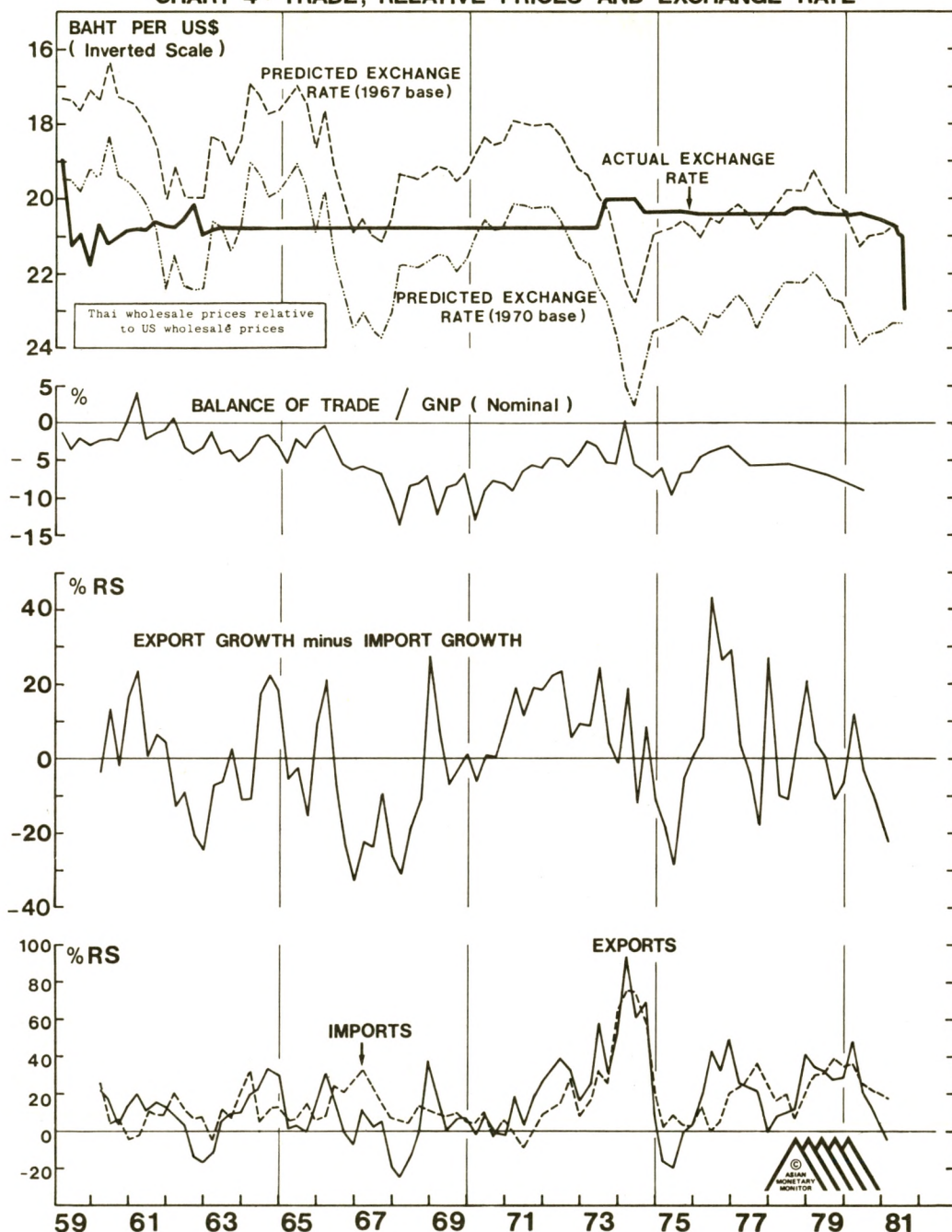
The devaluation has roughly restored the baht to its purchasing power parity level (see Chart 4). Relative to this level, the baht had become increasingly overvalued and this had serious detrimental effects for exports. Therefore, the devaluation will give a useful boost to exports, which will be further aided by good rice and agricultural crops this year. The fear is that devaluation will mean higher import costs. But oil prices have been relatively stagnant this year, and Thailand is now beginning to draw on its estimated 12 trillion cubic feet of offshore natural gas reserves, which should be gradually substituted for oil imports. Also, next year Thailand ought to benefit in terms of export competitiveness from the expected appreciation of the yen relative to the dollar, as Japan is by far Thailand's most important trading partner.

External factors therefore suggest that the devaluation should be a success. But devaluation of a currency primarily fulfils a 'switching' role. It changes relative prices so that demand is switched towards domestically produced goods. However, current account deficits are a reflection of the fact that domestic absorption is greater than production and if devaluation is to be successful the two must be brought into line. A devaluation can go some way to reducing demand in that it results in a terms of trade (and hence national income) loss, but demand must be further reduced relative to production if it is to have a favourable effect.

The July devaluation was politically unpopular and therefore the Bank of Thailand is under some pressure to make it work, rather than accept the possibility of further devaluations. Therefore, the time could now be right for a fundamental change of course by the Bank of Thailand which would restore the health of the economy in the longer term. There are some positive signs from the first half of this year. The year-on-year growth of the monetary base had dropped steadily from a rate of 18.9% in the second quarter of 1980 to 10.4% by May and 6.1% by June of this year, which represents the largest yearly drop in monetary base growth since the

THAILAND

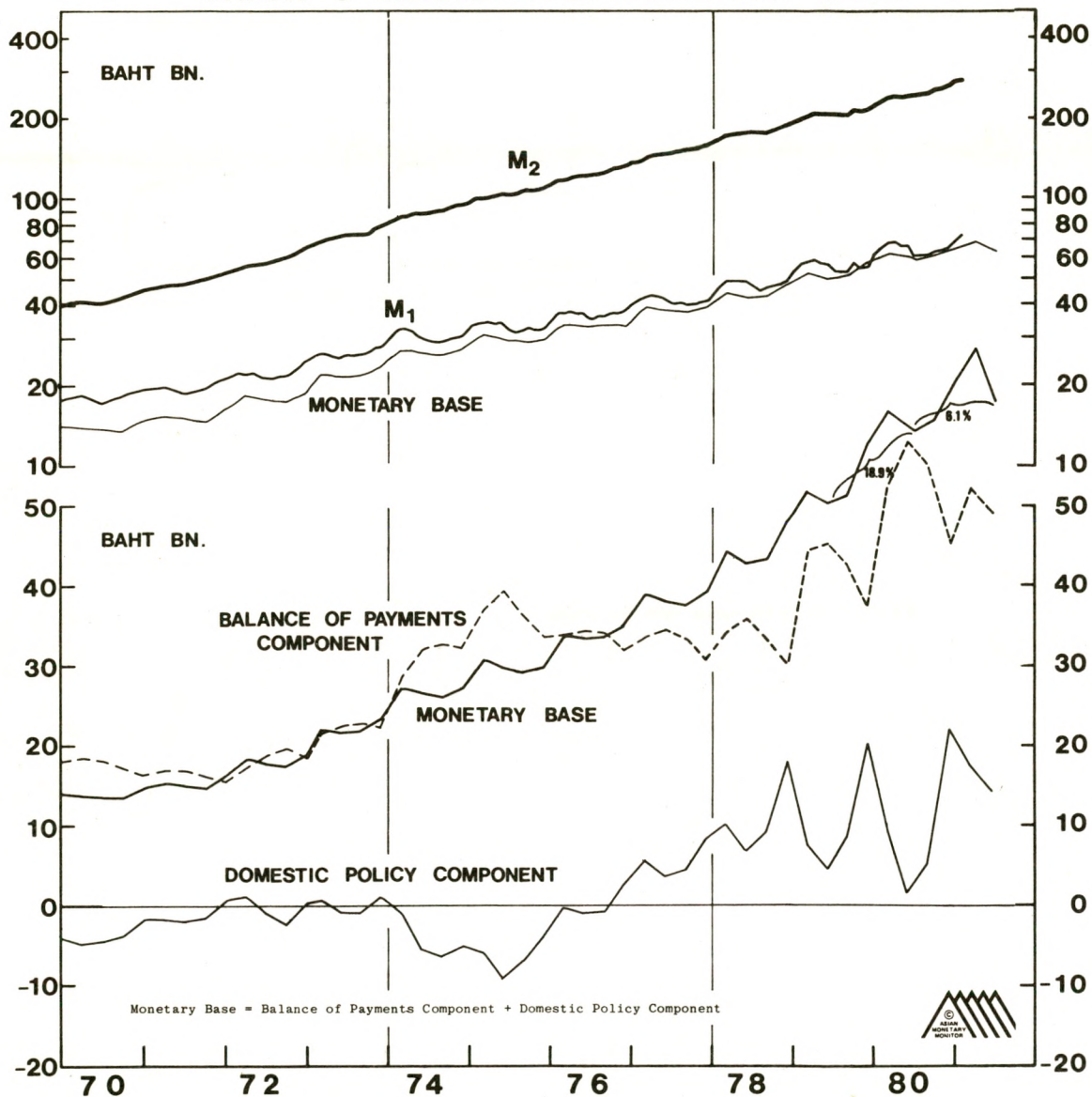
CHART 4 : TRADE, RELATIVE PRICES AND EXCHANGE RATE



The chart above illustrates the degree of over- or under-valuation of the baht by means of a comparison between the official exchange rate and a predicted exchange rate band, calculated on the basis of a purchasing power parity index derived from Thai and U.S. wholesale prices. It shows that for most of the period since 1973 the baht has been overvalued relative to its purchasing power parity but that the July devaluation has brought the official rate for the baht back into the same sort of relationship to its purchasing power parity that it enjoyed in the 1950s and 1960s.

THAILAND

CHART 5 : MONEY AND MONETARY BASE



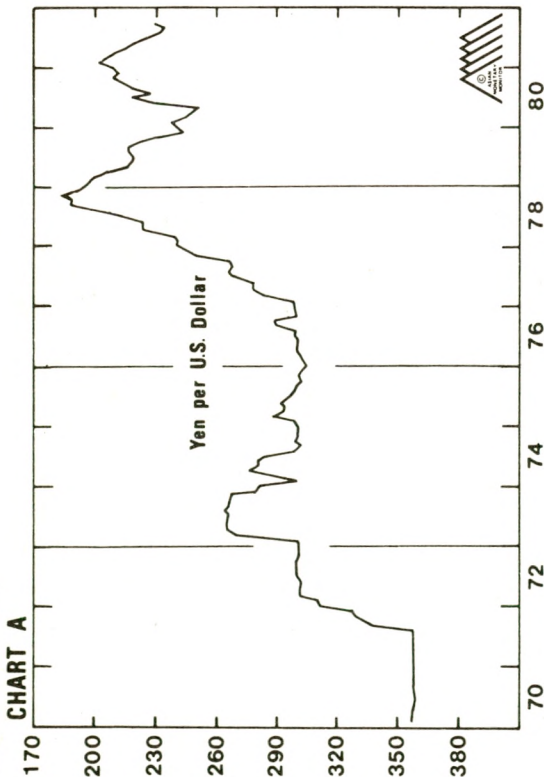
'crisis' period began. Also, in July of this year, the Bank of Thailand raised its loan rate from 13.5% to 14.5%. Both of these facts suggest that the Bank of Thailand is currently engineering a fairly severe monetary squeeze in order to reinforce the devaluation.

Although the trade deficit widened severely in the first five months of this year, the current account deficit in the first quarter reaching \$701 million, in July there were signs of a narrowing of the deficit. Imports were up 17.8% from the previous July, but this was more than made up for by the 30.1% rise in exports. This still represents a very large deficit but improved agricultural crops could see a continuation of this trend (although a favourable trend in export volume could be unfortunately offset by any continuing stagnation of commodity prices). Perhaps more importantly inflation has shown signs of easing. From a quarter-on-quarter rate of increase of 6.3% in the second quarter of 1980, consumer price inflation has eased to a rate of 2.4% in the second quarter of this year, the June index showing only a 0.6% rise over the previous months' level at a time when inflation is normally at a seasonal peak.

However, on the negative side the government deficit remains very large and there are no plans to reduce it. Rather, the plans are for increased spending. The government deficit in the first quarter of this year stood at 5,931 million baht, in a quarter when the deficit is usually seasonally low. This represented an 80% increase over the first quarter of 1980, a quarter in which the deficit was itself 205% up on the figure for the first quarter of 1979. The danger is that increasing budget deficits and artificially low interest rates will become increasingly incompatible with any desire for monetary restraint.

FORECAST: The maintenance of the policy of rapid monetary expansion with an increasing current account deficit has been made possible by heavy foreign borrowing. Borrowing from abroad was again very high in the first quarter of this year. However, since the second quarter of 1980, when foreign currency reserves were added to by \$457 million, reserves have been drawn down in each of the successive three quarters. This may mean that current account deficits will in future no longer be wholly counter-balanced by heavy overseas borrowing, in which case the only long term alternative is to allow current account deficits to reduce the growth of the monetary base. Charts 1 and 5 provide a strong indication that this has been occurring this year.

There is little doubt that the Thai economy is undergoing a monetary squeeze at the moment. This time it may well be the beginning of a determined attempt by the Bank of Thailand to bring the growth of the money supply back into line with GNP growth. Despite political instability, the longer term prospects for the Thai economy remain good and GNP growth remains at a relatively high level. If the Thai authorities are taking the first steps to bring the monetary situation under control then there is a light at the end of the tunnel.



In recent weeks the Japanese yen has recovered somewhat against the US dollar. From a low of ¥247.4 on August 4th, the yen has climbed more than 5%. The yen's decline against the US currency during July and August was primarily due to excessive speculative pressure in favour of the US dollar rather than any fundamental weakness in the yen. Heavy US dollar purchases during this period were based on market participants' anticipation that US short term interest rates would remain high. However a slight decline in Eurodollar rates (see Chart C) has confounded these expectations, and produced a sharp correction in the US dollar.

We expect the yen to continue firm against the US dollar so long as US interest rates decline. Chart B illustrates the overall competitiveness of the Japanese economy as far as the trade and current accounts are concerned. Japan's export growth continues to exceed that of its imports growth by the historically high margin of 20%, in spite of a slower level of economic activity in most OECD economies. Japan's trade surplus now seems set to exceed the previous record levels of mid-1978. An important element in Japan's formidable export achievement has been the Bank of Japan's striking record in restraining inflation. Tokyo consumer prices rose by a mere 3.7% in the year to August and there appears to be every

likelihood of this low rate of inflation being sustained - at least over the next six months or so.

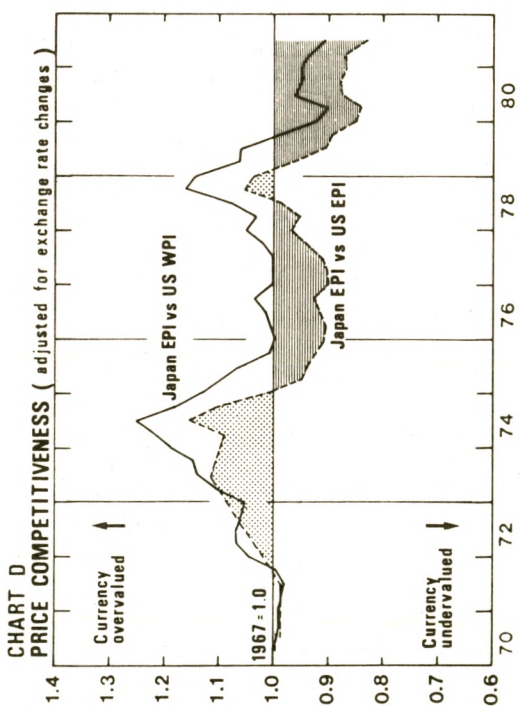
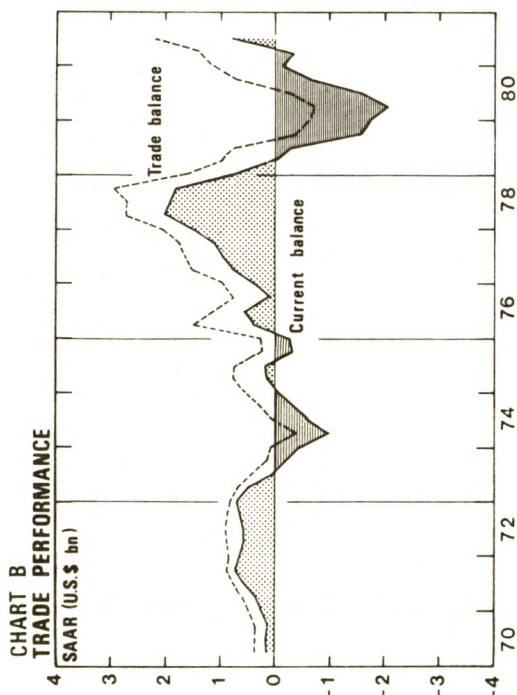
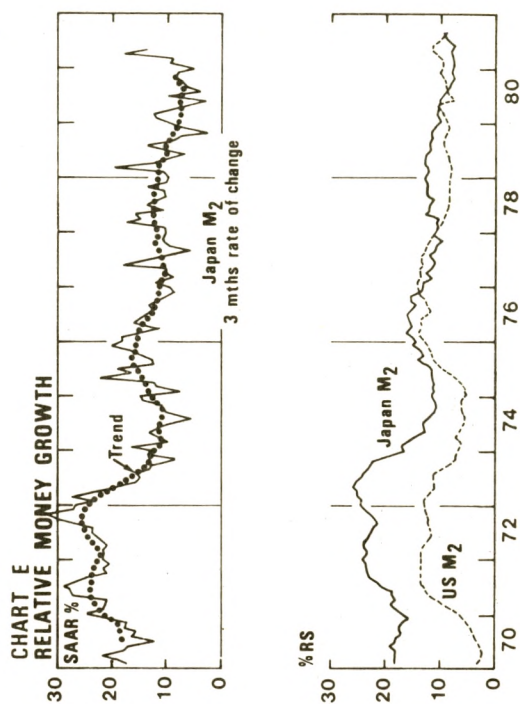
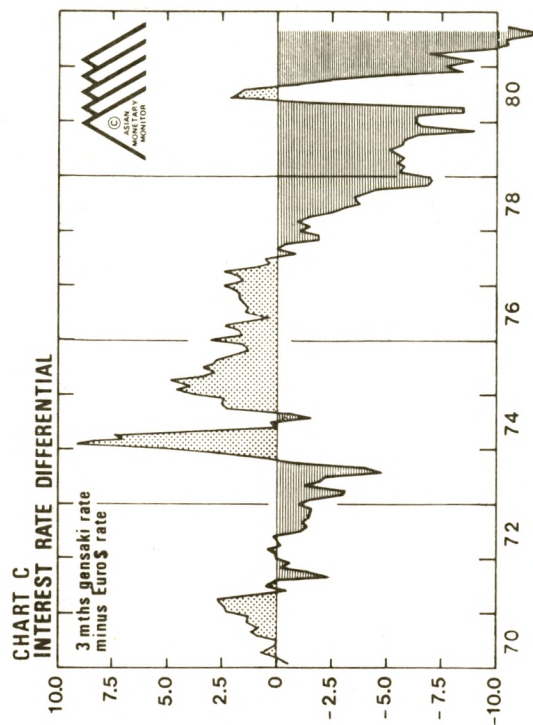
Although we anticipate that the yen will rise further against the US dollar, possibly to as high as ¥210 by year end, it is unlikely that the yen will also strengthen significantly against the European currencies, especially against the Deutschmark and Swiss franc. The reason for this is that the Bank of Japan is now the only major Central Bank which is deliberately targeting an increase in monetary growth. It has forecast that M2+CD growth will rise to between 10% and 10½% year-on-year by the beginning of 1982. This compares with a growth rate of around 7% in the year to December 1980. Within the context of rising real GNP growth, this increase in the domestic money supply is by no means excessive. However the Bank of Japan's relatively "easier" stance towards monetary policy contrasts with the highly contractionary stance being taken by the National Bank of Switzerland and, until very recently, the Bundesbank. The yen has appreciated more than 30% against the Deutschmark and Swiss franc since May 1980, and we do not expect these gains to be extended now that both the West German and Swiss trade accounts are experiencing a cyclical upturn.

ACTUAL FORECAST

Yen/US\$	1981 Q2	Q3	Q4	1982 Q1
FORECAST A				
Actual Range	212.6-228.2	225.0-247.4	220-240	220-240
FORECAST B			210-230	205-220

Forecast A assumes that US interest rates level out and begin rising towards the end of the year, in response to further resilience in the US economy.

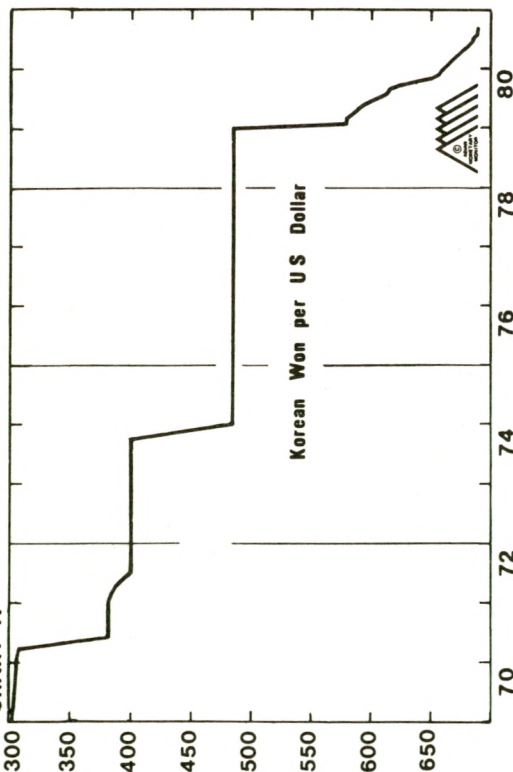
Forecast B assumes that US interest rates gradually decline into the first quarter of 1982.



EPI: EXPORT PRICE INDEX
SAAR: SEASONALLY ADJUSTED AT ANNUAL RATE
RS: RATE OF CHANGE OVER SAME MONTH OF PREVIOUS YEAR

KOREAN WON

CHART A



During the past nine months the Korean won has declined by a modest 4% against the US dollar. This fall, however, marks a significant improvement in the won's fortunes: in January 1980 the won was devalued by 16.5%, partly in an attempt to stimulate Korean exports. However the hoped - for export boom failed to materialise and the won slumped by a further 14% during the course of the year.

The relative strength of the won so far this year may best be explained by the cyclical improvement in the Korean economy which we expect to be maintained over the forthcoming twelve months. Hence we do not anticipate any major weakness in the won over this period, and it is unlikely that the Korean currency will slip below 725 by the middle of next year.

The back drop to cyclical recovery in the Korean economy lies partly with a long awaited upturn in exports. After a 12% year-on-year increase in total exports the third quarter of 1980, export values grew quite sharply and rose 33% in the year to July. This increase has been achieved in spite of sluggish economic activity in most developed countries, and any recovery in the OECD economies is certain to enhance Korea's export drive.

A vital element in the growth of Korean exports has been a significant reduction in domestic inflation. Consumer price inflation has fallen by over one third since the end of 1980 and currently measures around 24%. This fall is likely to continue as a consequence of a monetary contraction during 1978 and 1979 (M2 growth fell from 45% to 20% by the end of 1979) and the maintenance of comparatively low monetary growth since then. (See Chart E.) Although M2 grew by an apparently excessive 25% in the year to June, undeveloped banking systems monetary growth at this level is probably consistent with an inflation rate in the region of 15%. Indeed, consumer price inflation is likely to fall below 20% by the end of this year.

A further bullish influence in the won is that the growth in Korean imports has been fairly restrained. Total imports rose by 18% in the year to July. Although this growth rate is likely to accelerate as industrial activity rises, it is unlikely to create severe strains on the balance of trade, as occurred in 1978 and 1979 (see Chart B), unless the Korean authorities revert to an excessively expansionary monetary policy. Overall, Korea's balance of trade deficit will fall this year and could be as much as US\$500 million below 1980's US\$3 billion deficit.

Although a reduced trade deficit and lower inflation will form the basis for a relatively stronger won during the coming months, this should not be misconstrued as part of a transition to longer term strength: Korean inflation will simply remain too high for the won's recent firmness to be anything but cyclical.

Won/US\$	ACTUAL			FORECAST	
	1981 Q2	Q3	Q4	1982 Q1	
	FORECAST A Actual Range FORECAST B	672.8-685.0	685.1-690.2	770	785 685.0-700 695-710

Forecast A is based on a simple projection of relative price competitiveness shown on Chart D i.e. the exchange rate necessary to bring US and local price levels into line.

Forecast B is the most likely range in the absence of some major political or other external disruption.

CHART B

TRADE PERFORMANCE

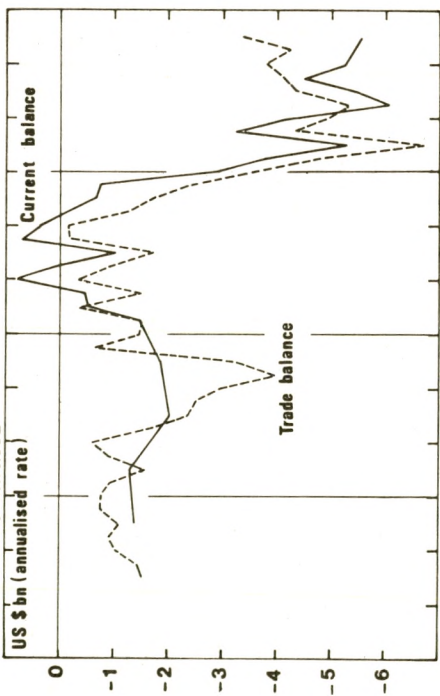


CHART C

INTERNATIONAL RESERVES

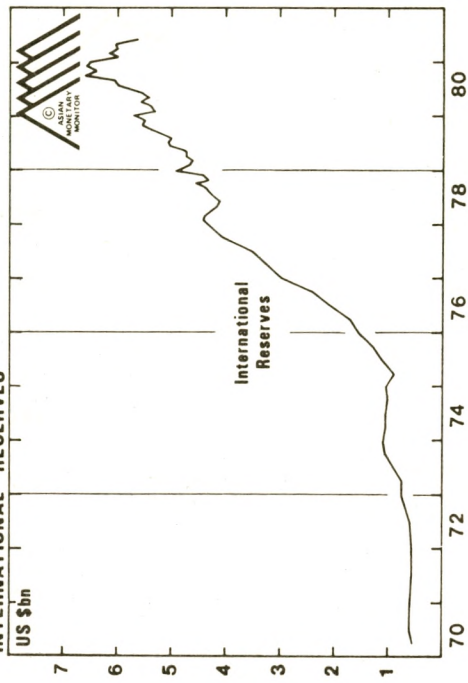


CHART D

PRICE COMPETITIVENESS (adjusted for exchange rate changes)

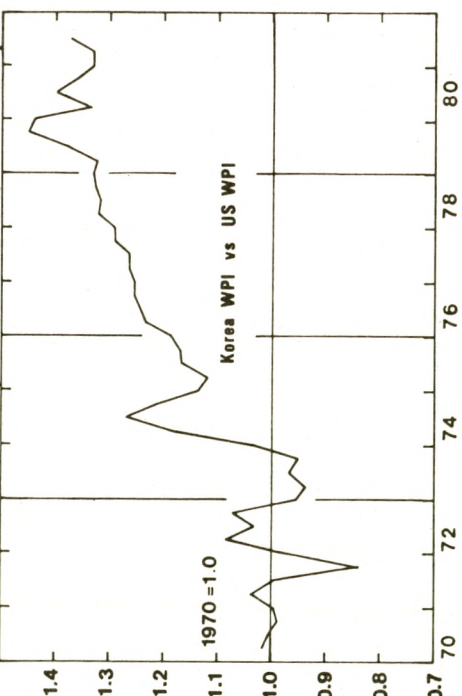
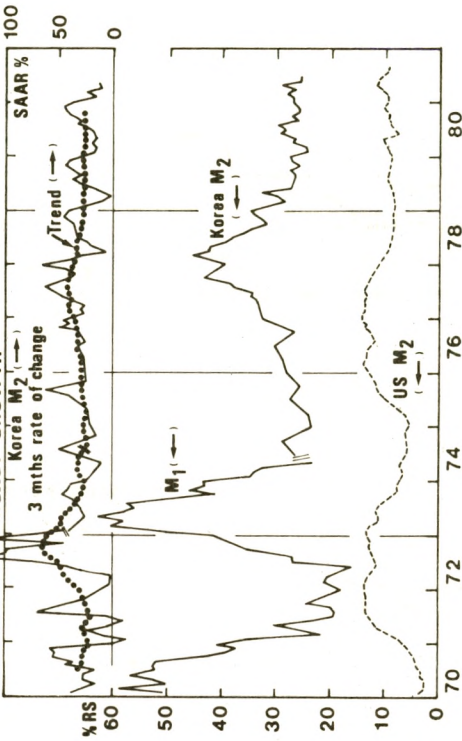


CHART E

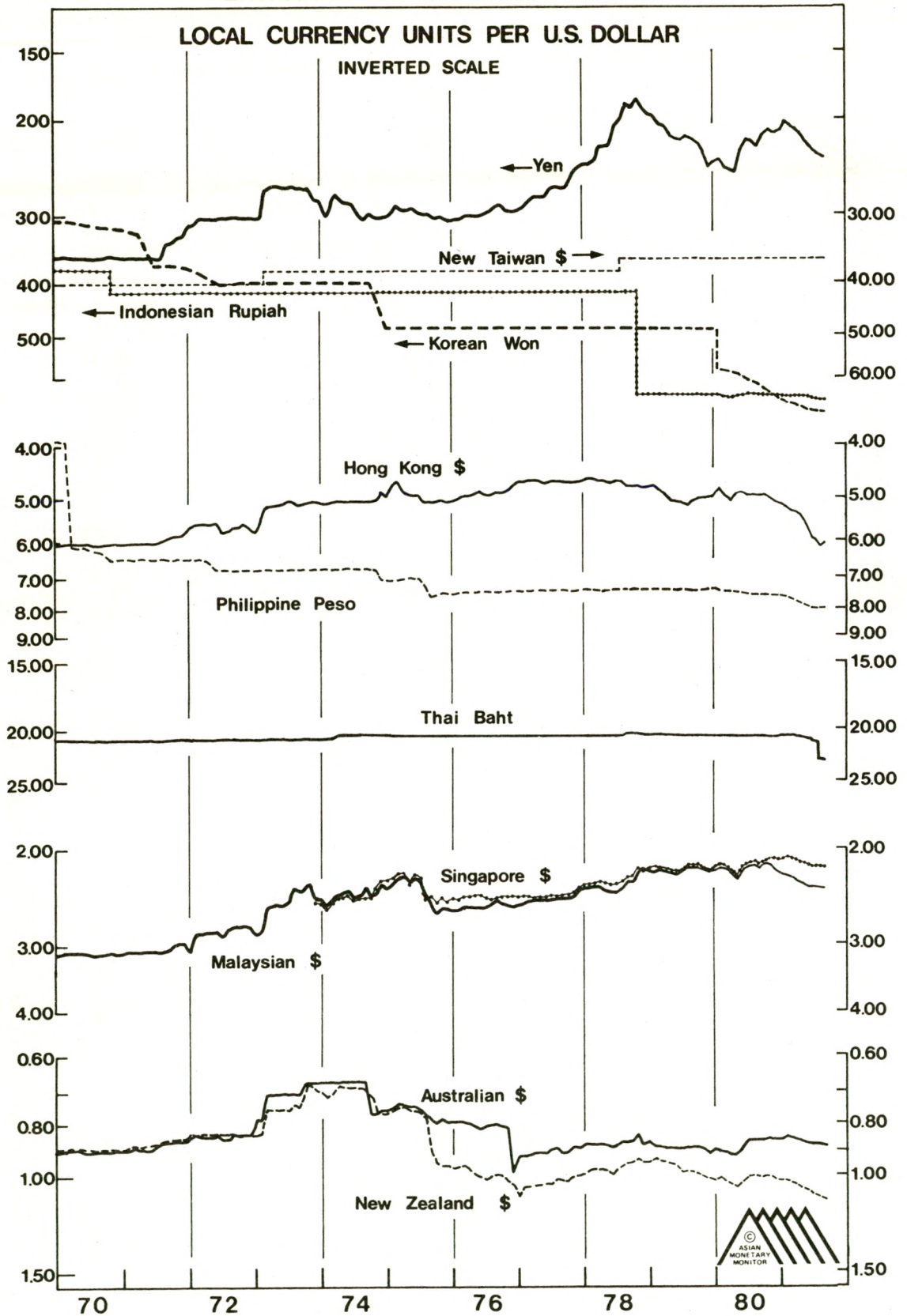
RELATIVE MONEY GROWTH



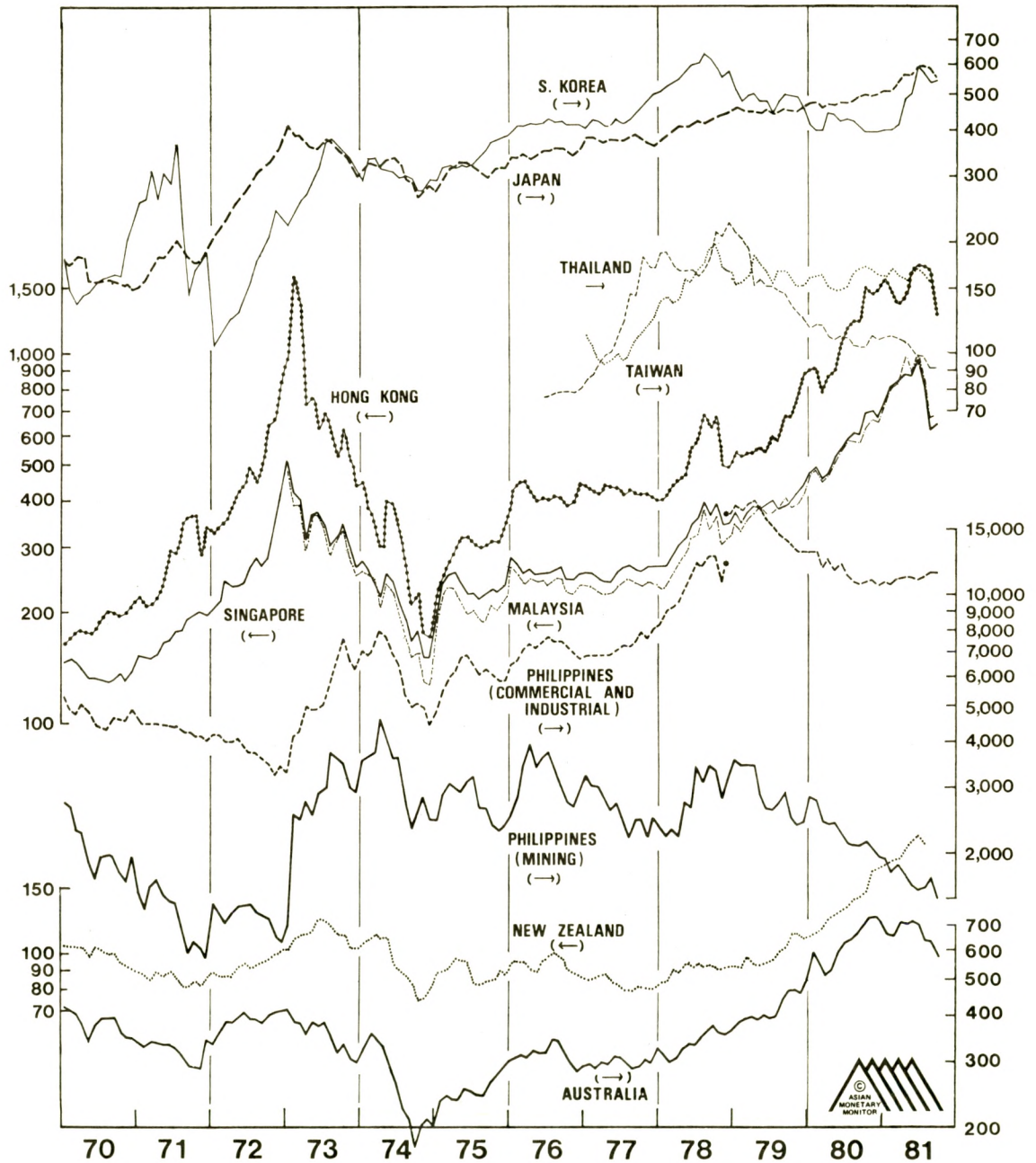
SAAR: SEASONALLY ADJUSTED AT ANNUAL RATE

RS: RATE OF CHANGE OVER SAME MONTH OF PREVIOUS YEAR

EXCHANGE RATES IN THE FAR EAST



FAR EAST STOCK PRICE INDICES



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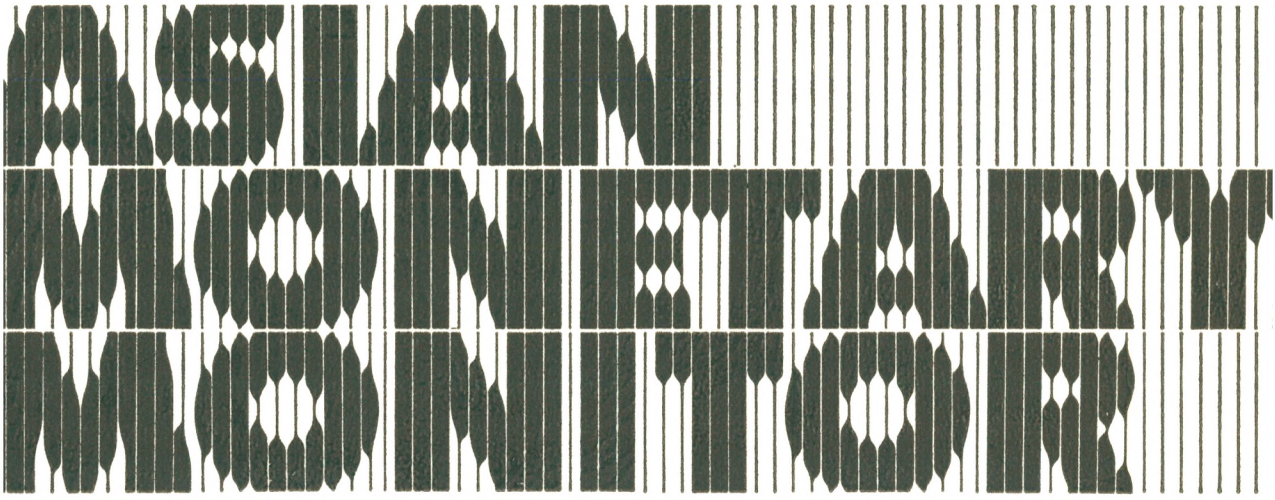




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CONTENTS

Page

REGIONAL SURVEY:
The Prospects for Growth

AUSTRALIA:
Sensible Monetary Proposals
from the Campbell Report

1

HONG KONG:
Four Approaches to Monetary Control

1

JAPAN:
Capital Investment through the Business Cycle

2

EXCHANGE RATE FORECASTS:
New Zealand Dollar
Singapore Dollar
Thai Baht

4

4

4

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CONTENTS

	Page
REGIONAL SURVEY	
The Prospects for Growth	2
AUSTRALIA	
Sensible Monetary Proposals from the Campbell Report	13
HONG KONG	
Four Approaches to Monetary Control	17
JAPAN	
Capital Investment through the Business Cycle	29
EXCHANGE RATE FORECASTS	
New Zealand Dollar	40
Singapore Dollar	42
Thai Baht	44

KEY TO SYMBOLS USED IN THE CHARTS

% RP - Percentage Rate of change over Preceding period.

% RS - Percentage Rate of change over Same period of
preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

REGIONAL SURVEY

THE PROSPECTS FOR GROWTH

Introduction

Many countries in South East Asia face the prospect of a slowdown in their levels of economic activity during the coming year. The high real rates of growth experienced by countries such as Singapore, Hong Kong, Malaysia and Australia during the past two years will prove, we expect, to have been the cyclical high points of their business cycles.

By contrast, we feel confident that many countries in Europe - which have typically experienced low or negative rates of real growth since the middle of 1980 - are now entering a period of easier overall liquidity and a cyclical upswing in their economies. These broad trends may well turn out to have important implications for the relative performance of stock markets in the two regions.

Since the economies of South East Asia encompass a very wide spectrum of stages of development, a broad range of natural resource endowments, and a large variety of different trading patterns, how, it might well be asked, is it feasible to make such broad generalisations in view of the wide structural diversity evident in South East Asian economies?

The answer, as was suggested in the first paragraph, lies with the fact that these structural differences do not substantially alter the economic mechanisms which cause business cycles. An examination of the monetary, balance of trade, and inflationary trends in the Asian regional economies suggests that a downturn in regional economic activity is upon us.

The Backdrop to the Region's Deteriorating Cyclical Position

The fundamental reason why there is a strong likelihood of slower growth in many regional economies lies with their failure to stem excessive monetary growth during 1979 and 1980. This is illustrated in Chart 1 which shows a surge in monetary growth in Hong Kong, Malaysia, Singapore, the Philippines and Thailand. Monetary growth continued at a relatively high level in Australia, and only Japan and Korea experienced a decline in monetary growth during 1980. The rises in monetary growth led to an increase in the overall level of liquidity in these economies which fuelled quite rapid growth in nominal incomes.

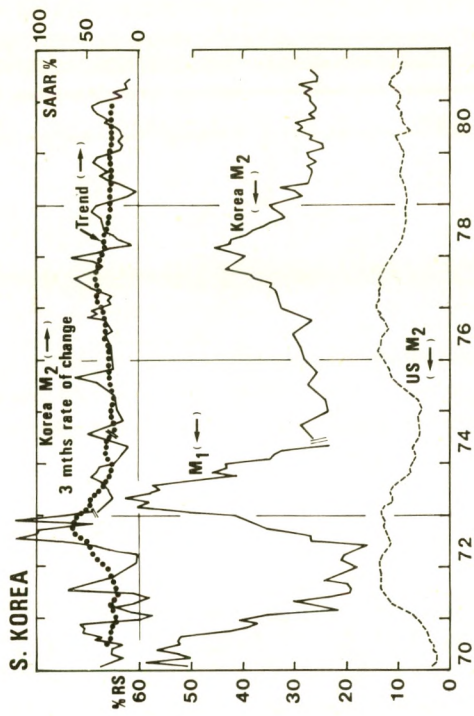
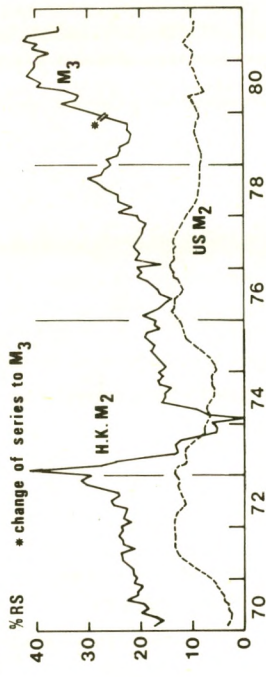
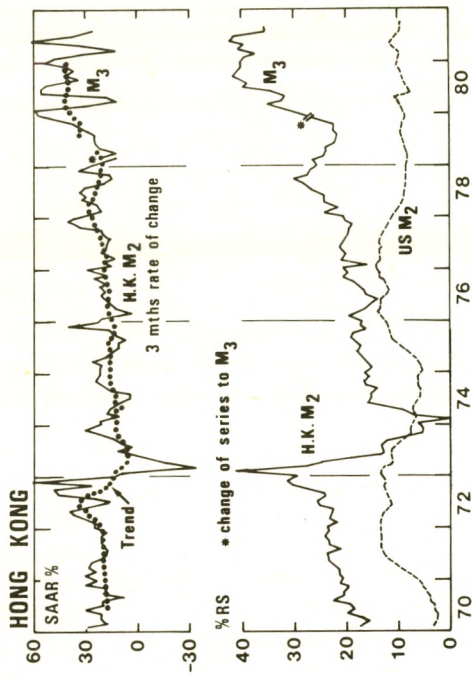
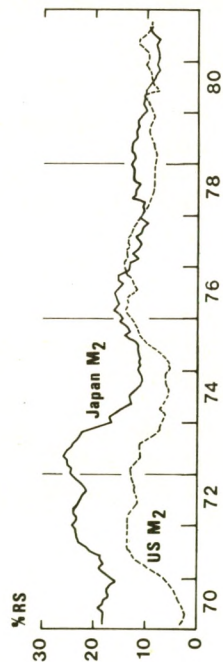
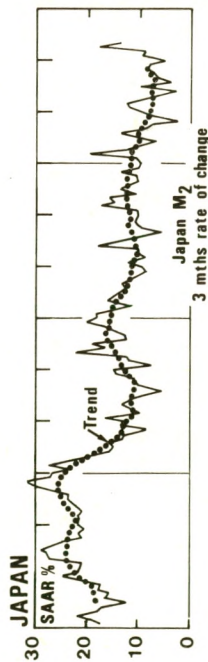
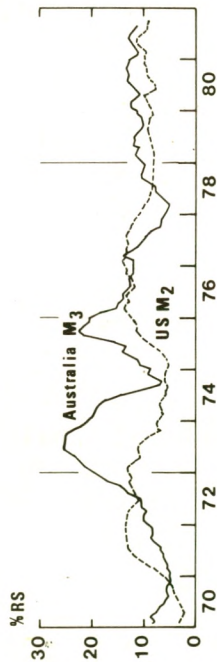
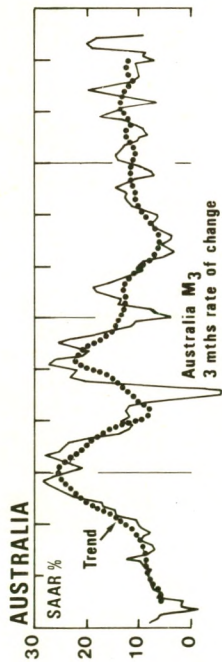
For various reasons, however, the growth in domestic liquidity in many South East Asian countries will not be maintained. The only important exception to this will be Japan. But the contention that most countries within the S.E. Asian Region face lower growth during the coming year can be examined with reference to the Japanese model. We have

outlined in many previous editions of Asian Monetary Monitor the reasons why Japan has been able to sustain relatively steady rates of real GNP growth since the first oil crisis. There are two key elements to their success. First, the Bank of Japan has allowed the yen to float on the foreign exchanges, so that the bulk of adjustments to external changes are borne by the exchange rate rather than by variations in the level of activity in the domestic economy. Second, the Bank of Japan has provided stable, low growth in the money supply, thereby minimising deviations in total nominal income. This combination of economic policies is a reliable recipe for avoiding quite sharp downturns in total economic activity. It is thus worth comparing the recent experience of other South East Asian economies with the Japanese model.

Singapore and Malaysia are both countries where the basic objectives of economic stabilisation are similar to that in Japan. The policy intention in both countries is to manage their local currencies in an attempt to reduce large fluctuations in their balance of payments and hence to avoid cyclical swings in monetary growth. This basic policy is supplemented by some measures in the domestic money markets to influence the money supply, with both countries setting targets for growth in the narrow monetary aggregates. However, it is clear from Charts 1 and 2 that this basic economic strategy has not been successfully implemented during the past three years.

The Bank Negara Malaysia, in particular, did not raise the external value of the Ringgit sufficiently to prevent the accumulation of large external surpluses. This is understandable in the light of very sharp oil price rises in 1979, but the fact remains that the large trade and current account surpluses built up during 1979 and 1980 were not offset in the local money market and hence monetary growth surged. M2 growth rose from a trough of 12% year-on-year in 1978 to as high as 30% in early 1980. The easy liquidity that this created helped push real GDP growth to 9% in 1979 and only marginally less during 1980. This year, however, domestic liquidity has tightened considerably. One cause of this stems directly from high monetary growth during 1980, namely a swift increase in domestic inflation which exceeded 11% in June of this year. At the same time, there has been a severe reduction in Malaysia's trade surplus. Just as the Bank Negara Malaysia failed to offset the impact of very large external surpluses on monetary growth during 1979 and early 1980, so the deterioration in Malaysia's trade account over the last year has been reflected in a large reduction in monetary growth with M2 having decelerated from 30% in early 1980 to less than 15% in the past year. Broad changes in monetary growth have their impact on the economy with a lag. With no sign that the external account is set to improve, we must assume that monetary growth will continue at a low rate. These two influences, combined with historically high interest rates imply that domestic liquidity will remain tight and this sets the scene for lower real economic growth in 1982.

CHART : 1
RELATIVE MONEY GROWTH IN THE ASIAN PACIFIC REGION



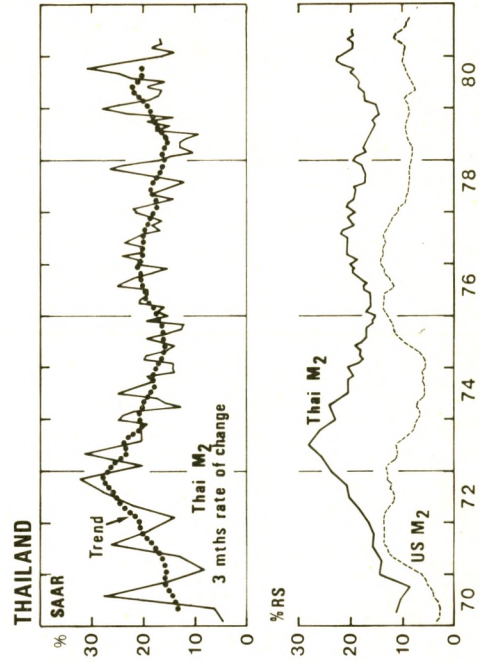
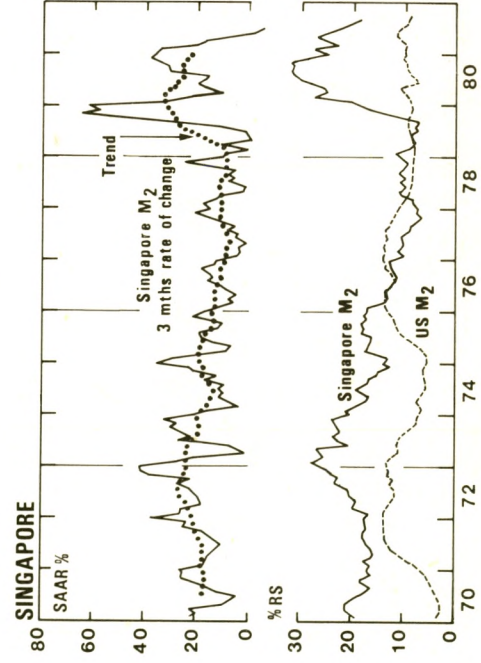
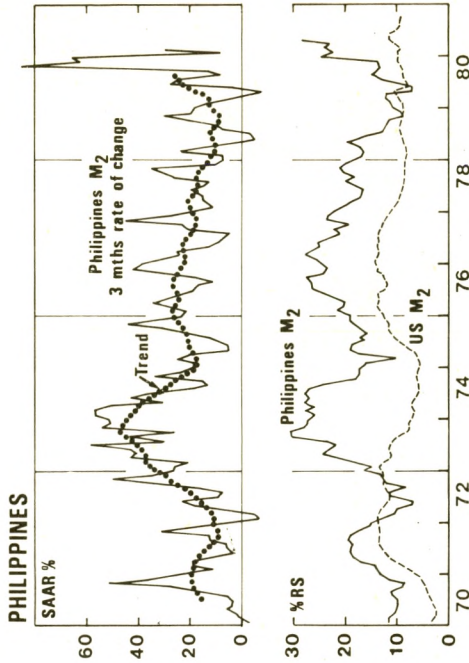
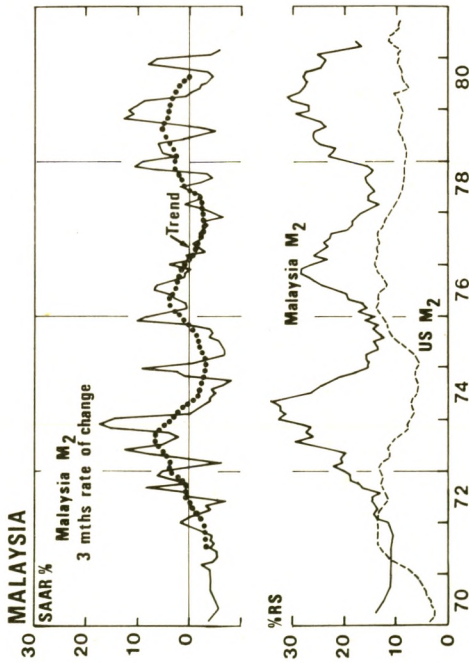
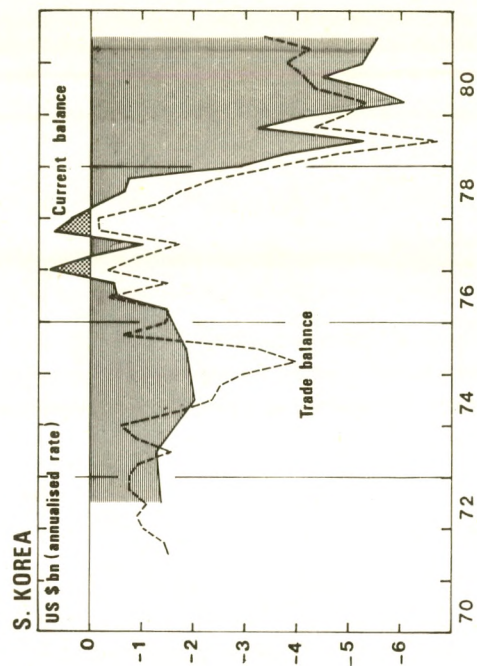
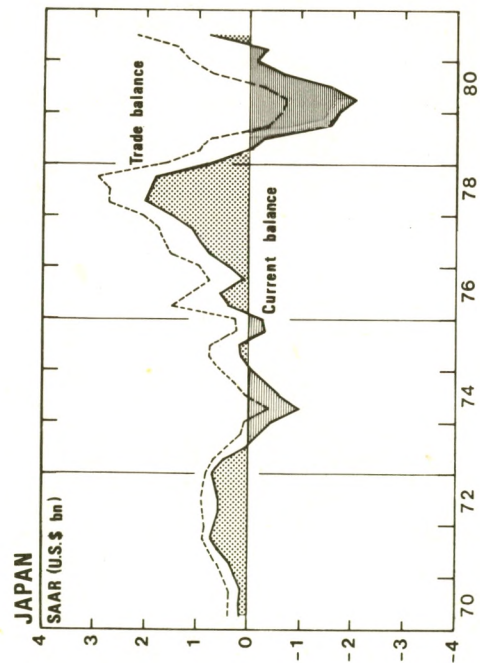
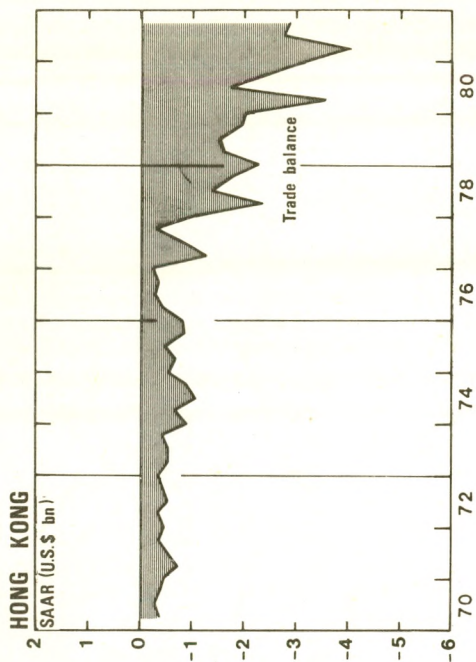
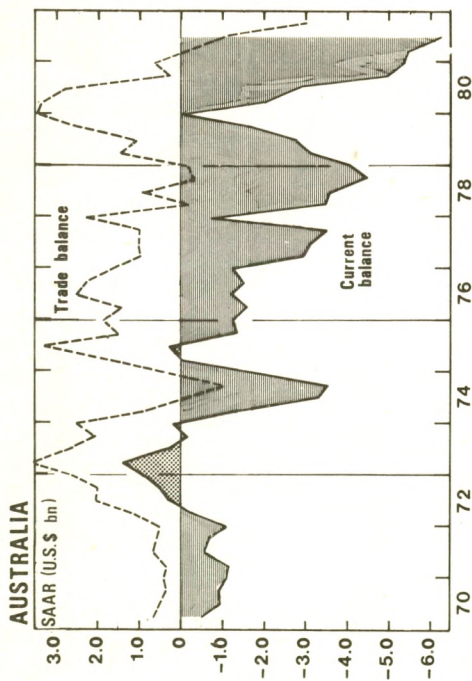
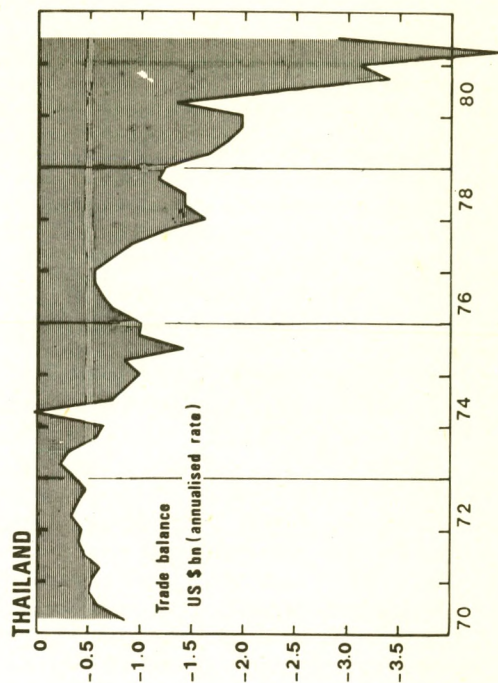
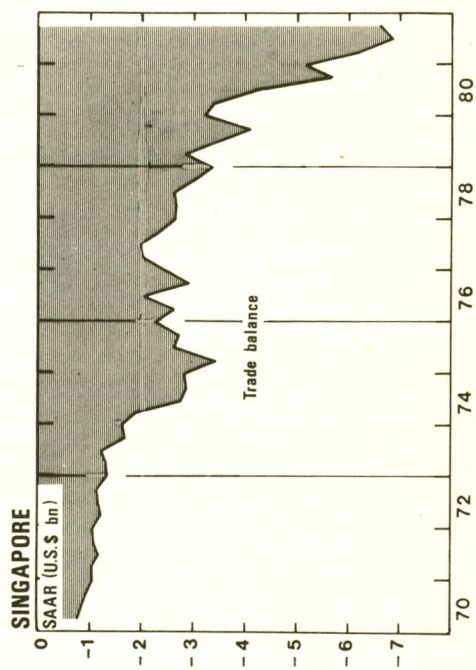
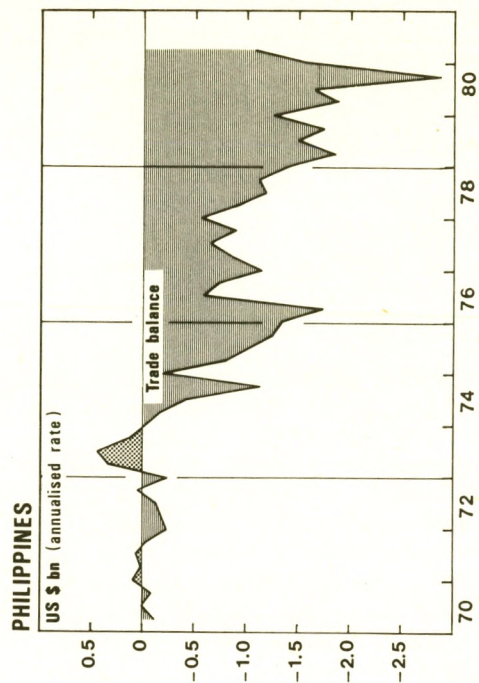
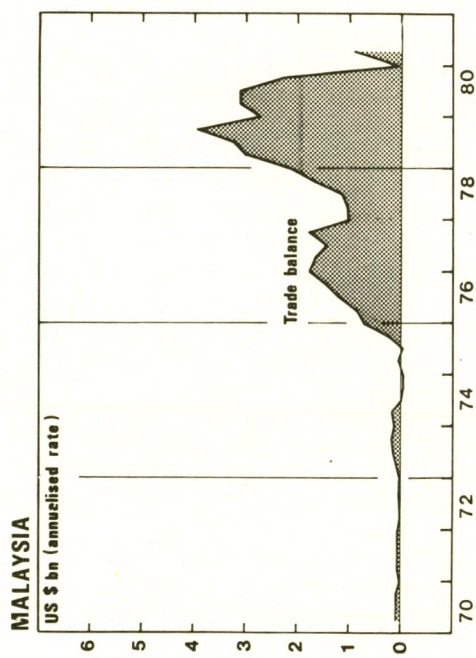


CHART: 2
TRADE PERFORMANCES IN THE ASIAN PACIFIC REGION





The economic situation in Singapore has been similar. M2 growth accelerated from around 9% year-on-year to over 30% between the third quarter of 1979 and mid-1980 as Singapore experienced burgeoning balance of payments surpluses and a rapid increase in international reserves. During the last year, however, as aggregate demand and inflation in Singapore rose relative to that of the US and Europe, the external surplus has been sharply reduced. As in the Malaysian example, this has been reflected in a slower monetary growth which is now running at roughly half the pace of 1980.

The basic differences between economic management policies in Japan and those in Singapore and Malaysia is that the latter pair have failed to ensure stable monetary growth. Large fluctuations in monetary growth are virtually always followed by cyclical swings in nominal income growth. As is evident in Chart 1, both Singapore and Malaysia have experienced sharp falls in monetary growth in the past year. The causes of this decline - deteriorating external accounts as economic activity in these countries continued firm in contrast to the US and Europe - are not about to be reversed and hence a downturn in nominal income growth appears extremely likely.

A similar pattern is beginning to emerge in Australia - an economy which also bases a major part of its economic management policy on complementary use of a managed exchange rate and direct Reserve Bank control over monetary growth. So far, there has been no major turndown in monetary growth and the economy continues to be relatively firm. However, the corollary of this is that there has been a continued decline in Australia's current account, which is now in a record deficit, and prolonged upward pressure on inflation and interest rates. This situation is unsustainable. The current account deficit will ultimately force a contraction in monetary growth as the deficit starts - and this is now happening - to exceed the size of private capital inflows. With inflation and interest rates both at high levels, domestic liquidity will tighten and a recession ensue.

The basic mechanism behind the likely downturn in economic activity in these three countries is exactly the same. Domestic monetary policies were effectively relatively 'easy' during 1980 at a time when monetary policy in the US, and in Europe, was restrictive. Economic activity in these regional economies, therefore remained relatively more buoyant, but only at the cost of deteriorating external accounts and rising inflation. At some stage one or both of these last two influences will produce a reduction in monetary growth either as a consequence of the authorities being unwilling or unable to prevent an external drain on the money supply or following domestic pressures to reduce inflation. Either way overall liquidity will contract and economic activity will decline.

Hong Kong and Thailand illustrate a further variant on this theme. Although they have very different monetary institutions - the former exercising policy through interest rate regulation with a freely floating currency, and the latter

attempting to achieve indirect control of monetary growth through a pegged exchange rate - the cyclical problems they have faced, and the authorities' response have been very similar. Once again, excessive monetary growth in their domestic economies has caused their business cycles to fall out of phase with the cyclical trend in European economies and in the US. The costs of this policy have, again, been rising domestic inflation and downward pressure on their external accounts. However the authorities in both countries have effectively cushioned their domestic economy from the full impact of these trends by allowing a depreciation of the Hong Kong dollar and the baht. In Hong Kong's case, the authorities had little choice since there has been no reliable mechanism to counter Hong Kong dollar weakness. In Thailand's case, the costs of defending the baht in terms of high local interest rates, a burgeoning trade deficit, and soaring foreign indebtedness apparently became too severe and the baht was devalued by nearly 9% in July.

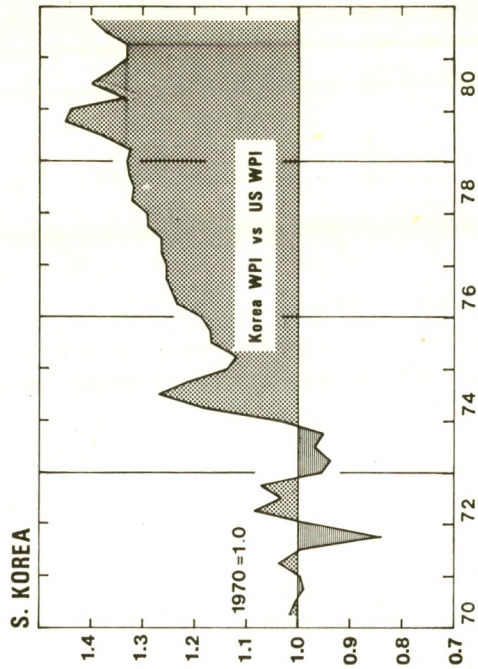
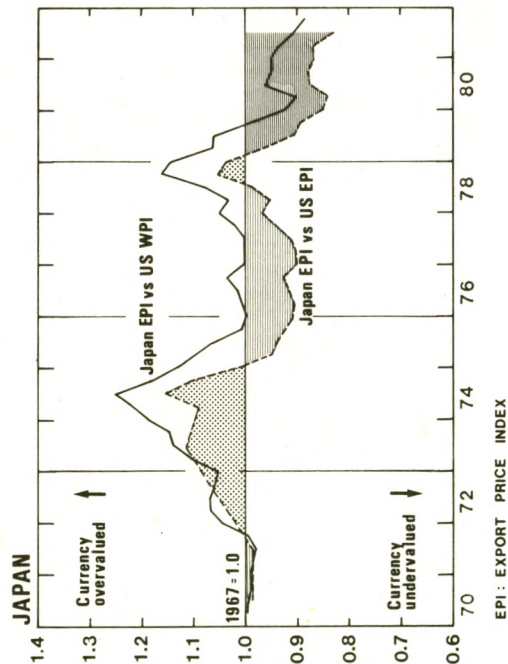
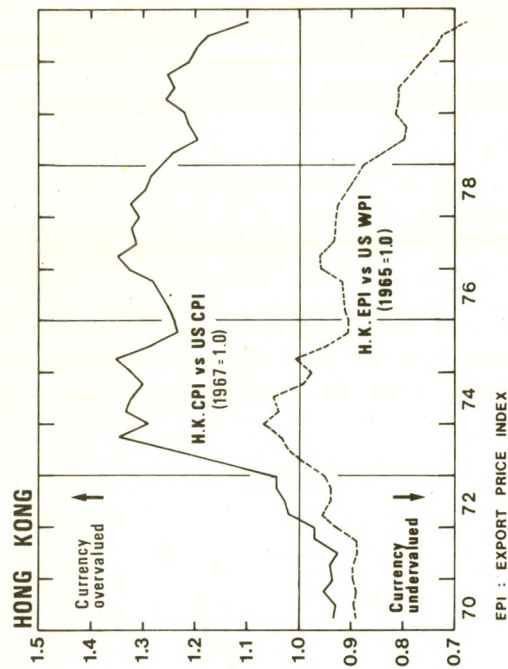
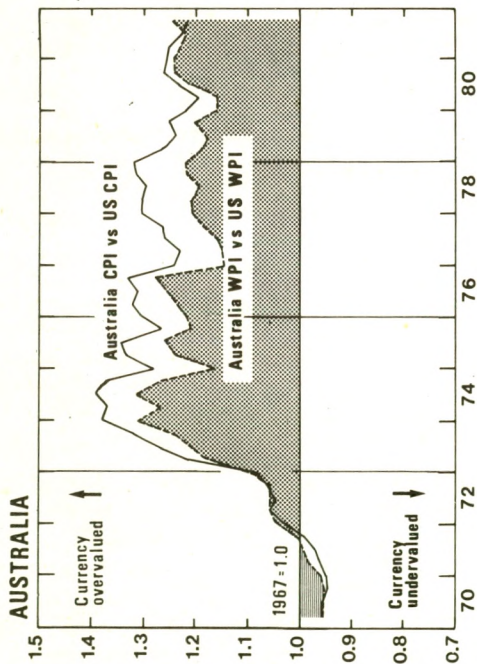
Nevertheless it is important to realise that depreciation of the domestic currency under such circumstances really only postpones the day of reckoning. Currency depreciation is a sign either that domestic demand is too high relative to that of the economy's trading partners, or that domestic inflation is relatively too high, or both, and it does not in itself correct the underlying source of currency weakness. For both Thailand and Hong Kong the economic choice open to their authorities is straightforward. Either they can continue to allow further depreciation in the baht and the Hong Kong dollar, or they must reverse the trend in domestic monetary growth. Chart 1 suggests that both economies, as in the case of Singapore and Malaysia, are taking steps to reduce their excessive expansion of the money supply. In comparison with the Japanese 'model', Hong Kong's monetary policy clearly lacks one of the essential ingredients for relatively stable real growth. For although the Hong Kong dollar has been allowed to trade freely on the foreign exchanges thereby ameliorating the downtrend in Hong Kong's trade deficit (see Chart 2) domestic monetary growth has been highly cyclical. And it is broad movements in monetary growth which are responsible for the trends in nominal GDP growth.

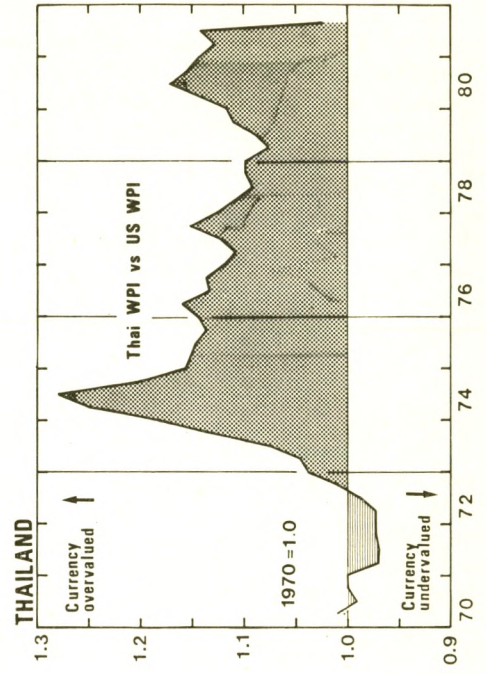
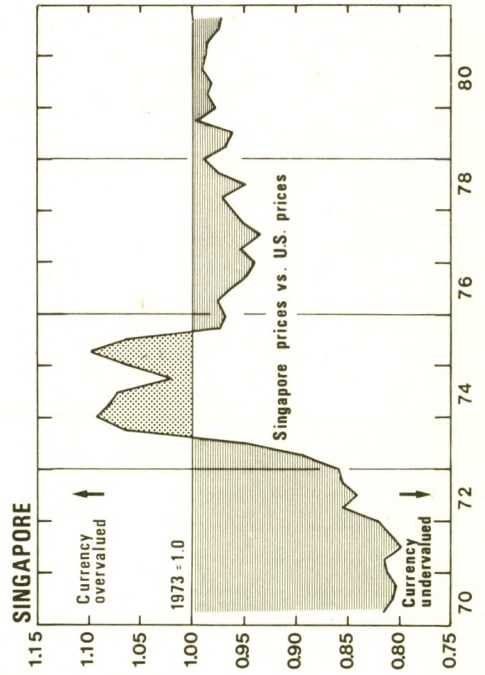
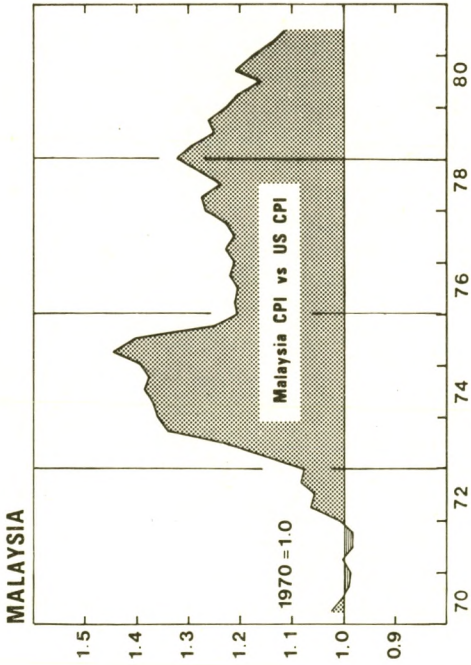
A Note of Caution

We have argued that many countries in the Asian Pacific Region are due for a period of tighter liquidity and a cyclical slowdown. In countries such as Australia, Malaysia and Singapore the background to this slowdown lies primarily with their Central Bank's decision not to offset large trade or balance of payment surpluses accumulated during 1979 and the first half of 1980, thereby generating accommodative monetary growth. These countries must now adjust to this period of excessively easy monetary growth. However, we should also remember that the global economic environment has changed markedly since then. If the Federal Reserve in the US is to be believed, it will engineer an especially stringent monetary policy up until the end of 1982, and beyond. This will

CHART : 3

PRICE COMPETITIVENESS (adjusted for exchange rate changes) IN THE ASIAN PACIFIC REGION





undoubtedly produce a sharp decline in US inflation if the Federal Reserve adheres to its monetary targets. It is also likely to pull the US into recession. Falling inflation and declining real incomes in the US will prolong the cyclical downturn that is likely in many countries in the Asian Pacific Region. This statement is supported by the observation that many countries in the region have currencies which are overvalued in terms of their underlying price competitiveness (see Chart 3). It is therefore more difficult to be sanguine about the prospects for an export led recovery for countries such as Australia and Malaysia.

CONCLUSION : What are the circumstances under which high real growth rates may be maintained? In our opinion, the only reliable way any country can sustain relatively high rates of real growth is when a) its central bank provides a stable monetary policy; to ensure that the level of economic activity in the domestic economy also remains fairly stable, and b) its central bank ensures monetary growth is maintained at a low level; to ensure that the level of domestically generated inflation is kept under control, and finally c) that the country's exchange rate is allowed to float (i.e. adjust to market forces) on the foreign exchanges, so that the bulk of adjustments to changes in the external account are borne by the exchange rate, rather than by variations in the level of overall activity in the domestic economy.

Japan is the only regional economy that has successfully implemented the economic policies described above. It is thus the only economy where we may be confident that real GDP growth next year will at least equal that of 1981. Most other economies in the region have, for one reason or another, allowed monetary growth to follow a cyclical path. This virtually assures that the level of economic activity in those countries will also fluctuate quite widely. In each of the economies examined above, monetary growth is currently in a downtrend. The full consequences of this will be felt during 1982 in terms of slower real growth.

AUSTRALIA

SENSIBLE MONETARY PROPOSALS FROM THE CAMPBELL REPORT

The recently published "Final Report from the Committee of Enquiry into the Australian Financial System" is, as its title may suggest, remarkable in the breadth of its coverage. The so called Campbell Committee has examined the government's monetary and fiscal policy instruments, its exchange rate strategies, the range of financial intermediaries, the problems of company finance and lender security, and the competitive structure of the financial markets. The report was critical of a wide range of current government strategies, but in this article we will only examine the Committee's proposals to reform monetary policy in Australia.

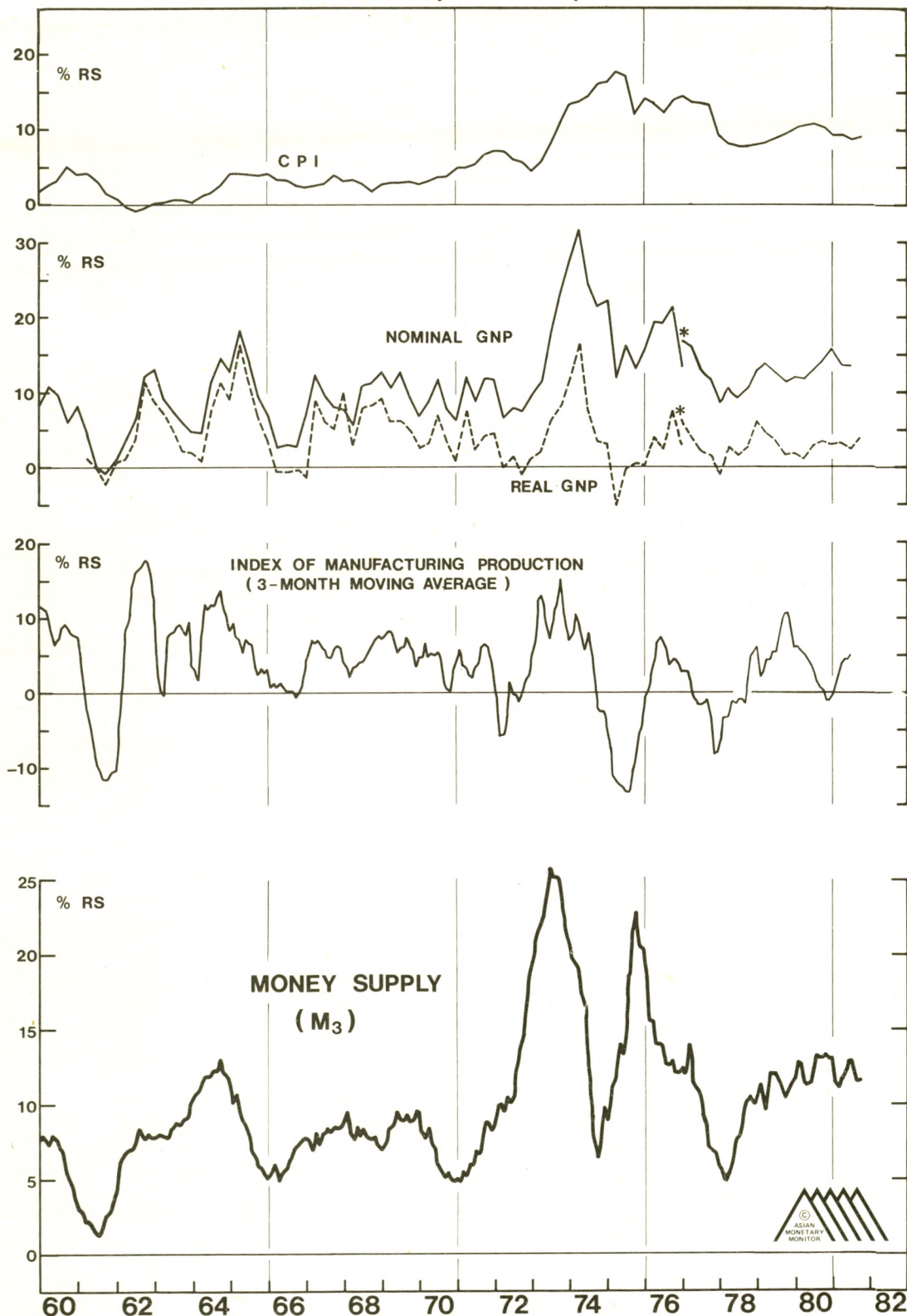
The Committee's criticism of Australia's present methods of monetary policy is developed along two lines. First, a recurrent theme in the Committee's recommendations is a basic commitment to the "free market" principle. They argue that the current level of official intervention in the Australian financial system is excessive. This conclusion appears to reflect the authors' philosophical predilection, but their view is developed in conjunction with a rigorous examination of the authorities' existing monetary and exchange rate management techniques. This represents the second prong of the Committee's attack, for they find that a high level of official regulation is an inefficient method of conducting monetary and exchange rate policy.

It is worth reviewing the extent to which the Australian authorities intervene in the financial system whilst conducting monetary and exchange rate policy. They regulate a wide spectrum of interest rates and yields including mortgage rates, some bank lending rates, government and "semi government" debt yields in the primary market. They exercise control over the rate of growth of bank lending both through quantitative ceilings and moral suasion, and influence the composition of banks' assets through the Liquids and Government Securities ratio convention. The authorities also 'manage' both spot and forward rates of the Australian dollar against the US dollar, whilst simultaneously restricting the export of most types of capital and the imports of a variety of goods through a complex system of exchange controls.

The Committee begins its review of Australian monetary policy by outlining what we would regard as a crucial distinction between the Reserve Bank's role in ensuring prudent management of Australia's financial system and its responsibility in providing an appropriate monetary policy. Whereas in the past the Reserve Bank appears to have been primarily concerned with its supervisory role in the Australian banking system, the Committee has sought to change the emphasis of Reserve Bank responsibility in the direction of a reliable monetary policy. The authorities, the authors argue, "can make a major contribution

AUSTRALIA

CHART 1 : MONEY, OUTPUT, AND PRICES



*Change of data series.

to the achievement of long term price stability,.... by maintaining relatively steady and restrained growth in monetary aggregates.... (for) inflation cannot persist for long without an accommodating growth in monetary and financial aggregates". (page 52)

The Campbell Committee has therefore re-emphasised the importance of stable, moderate, monetary growth. The Reserve Bank has in fact published money growth targets since 1976, but, in spite of the array of controls outlined above, it has met with only moderate success in achieving them. During each of the past three years, for example, M3 growth in Australia has been at a faster pace than was desired. However the Campbell Committee, having stated that control over monetary growth is an important objective, then proceeds to itemise a number of recommendations designed to assist the Reserve Bank in meeting this goal.

These recommendations amount to a radical re-appraisal of Australia's current monetary and exchange rate policies. At present, Australian monetary policy is conducted, broadly, through efforts to control the rate of growth of banks' lending. The principal instruments of this policy are quantitative and qualitative lending controls backed up by the two liquid asset ratios - the Statutory Reserve Deposit ratio and the Liquids and Government Securities ratio. The Committee has proposed major revisions to key elements of this system.

It recommends that the Reserve Bank's power to impose either quantitative or qualitative lending controls be abolished. In their place the Campbell Committee would like to see more restrictive control over the underlying sources of credit and monetary growth, with the ultimate distribution of credit being entirely market-determined through an unregulated interest rate mechanism. Previously the Reserve Bank concentrated most of its efforts on trying to limit the growth of bank lending and less on the financial mechanisms underlying the expansion of credit. Thus the quantitative and qualitative controls on bank lending that occurred in 1980 failed to stem the availability of total credit because the continued growth of the sources of money and credit stimulated expansion of non-bank financial intermediaries.

In place of regulated interest rates and restrictions on banks' asset growth, the Campbell Committee proposes a new basis for Australia's monetary policy. They recommend that monetary policy should primarily be conducted through a variable reserve ratio and, most importantly, that the definition of reservable assets in the banking system should be limited to cash and deposits at the Reserve Bank. The authors then also stipulate that trading banks should be restricted from obtaining reservable assets from the Reserve Bank and that Reserve Bank discounting of short-dated government stock "should never be at a price which conflicts with the Reserve Bank's open market operations". (page 763) The Committee also recommends that bank holdings of government securities "should

not be prescribed for monetary policy purposes," (page 75) as is the case with the present Liquids and Government Securities ratio.

In other words, the Committee is effectively proposing that monetary policy be conducted through control over the rate of growth of the monetary base. Indeed, the authors of the Campbell Report even discuss the feasibility of specifically targeting the growth rate of the monetary base - in a way akin to the practice of monetary policy in West Germany and Switzerland - but reject this method on the grounds that the concept of the monetary base does not enjoy the public recognition of aggregates such as M3. The crucial aspect of this recommendation, however, is the Committee's proposal to redefine "reservable assets" in the Australian banking system so as to include only liabilities of the Reserve Bank. Under such an arrangement, the source of monetary and credit creation in Australia would be entirely under the control of the Reserve Bank. The Reserve Bank would thus be able to act directly to offset excessive or insufficient monetary growth (by reducing or increasing the quantity of reserves in the banking system) rather than indirectly, as at present, by encouraging changes in the price at which banks lend funds. Under the system proposed by the Campbell Committee, changes in interest rates in Australia would be a symptom rather than, as now, an unreliable lever for faster or slower monetary growth.

Moreover, the Campbell Committee has not attempted to skirt the thorny question of exchange rate policy. Given that they attach a high priority to monetary control, and given that they have recommended a number of domestic institutional changes to implement this policy, it is only logical that they propose a more or less freely floating Australian dollar. This prevents the Reserve Bank from adding to monetary growth if it insists on managing the Australian dollar at a rate below its market value, or restricting monetary growth if the exchange rate is at "too high" a level. The domestic institutional changes which the Campbell Committee has proposed are, in our opinion, appropriately designed to facilitate direct control over monetary growth. Continuation with the present managed exchange rate or a return to a rigidly fixed exchange rate would only prove to be a constraint on the effective implementation of monetary control.

The Campbell Enquiry represents a major step forward in formulating an effective anti-inflationary policy in Australia. The Committee has recommended a policy of direct control over monetary growth and proposed a number of major institutional reforms aimed at eliminating the inefficient and outmoded monetary instruments currently in use. If the Campbell Committee's conclusions are adopted by the Australian government, we are confident that they would form the basis for a reliable, credible, domestic monetary policy.

FOUR APPROACHES TO MONETARY CONTROL*

There are two basic methods of controlling money in an economy; the first method involves setting the quantity, while the second method involves setting the price of money. In discussing different methods of controlling the money supply or the aggregate quantity of money in an economy we may call the first method the direct method, and the second the indirect method of control. For each of the two methods of controlling the quantity of money or monetary growth, there is one satisfactory or feasible approach which is likely to be successful - providing certain conditions are met - and an alternative approach which is unsatisfactory. This gives us a total of four approaches:

(A) Direct Methods of Money Supply Control

- (1) Regulating the reserves of the banking system.
- (2) Quantitative ceilings on bank assets or bank liabilities.

(B) Indirect Methods of Money Supply Control

- (1) Setting interest rates
- (2) Setting the exchange rate

My task this evening is to examine the problem of the management of monetary policy in Hong Kong with reference to this framework. I shall first demonstrate which methods of monetary management are feasible and desirable, and which methods are either not feasible or are not desirable. As an aside I shall make a few comments on liquid asset ratios and how the fixed exchange rate used to operate in the period before 1972.

My conclusion is that the course currently being pursued by the Hong Kong authorities in their attempts to conduct monetary policy in Hong Kong are doomed to failure in the long term, and that unless they change their course, the Hong Kong economy will suffer damage due to (1) increased governmental intervention and (2) continuing monetary instability. Let me caution you by saying that I do not believe the results of this policy will be immediate catastrophe. As Adam Smith said, "There is much ruin in a nation" - in other words our economic system - our free market economy - is highly resilient and it can put up with a great deal of disruptive intervention, bureaucratic waste and inefficiency. Nevertheless, I believe that the path currently being pursued in Hong Kong is the wrong one, and it is desirable for the people of Hong Kong, for the healthy development of our financial system, for the suppliers and users of financial services, and for the overall stability of the Hong Kong economy that the authorities recognise they are on a slippery slope and that they step off it before they are engulfed in the mire.

* Adapted from a talk given by John Greenwood to the Hong Kong Economics Association at a panel discussion on December 10th, 1981 under the title "The Hong Kong Economy Under High Interest Rates".

I therefore turn to consider one by one the four different approaches to controlling the money supply, and their application to the circumstances of Hong Kong's economy today.

(A) Direct Methods of Money Supply Control

(1) Regulating the reserves of the banking system

Hong Kong does not have an orthodox central bank. By that I mean that the Licensed Banks and Deposit-Taking Companies (DTC's) do not maintain reserve deposits or even working balances with the monetary authorities - the Exchange Fund. It follows that the authorities lack any lever or mechanism with which to regulate the quantity of bank reserves (reserve assets) in the conventional sense. (N.B. "Liquid Assets" are not reserves - see box on pp. 20-21.) In an orthodox system commercial bank reserves correspond to liabilities of the monetary authority. In Hong Kong the only liabilities of the Exchange Fund are (1) Certificates of Indebtedness (CI's) and (2) Coins, which together correspond to the total HK\$ currency issue and (3) Debt Certificates held by the Treasury which cancel out in a proper consolidation of the authorities' accounts. This leaves CIs and Coins, which are supplied passively. The volume of CIs and Coins could in theory be regulated, but in practice they are not, and this would in any case be a very crude instrument to use.

Thus one key difference between the balance sheet of a central bank and the balance sheet of the Exchange Fund is that whereas a central bank can expand or contract its assets and hence its liabilities (i.e. the monetary base) at will, the Exchange Fund does not have the ability to do so in such a way as to affect banks' reserves. In other words the Exchange Fund, by virtue of the limitations of its balance sheet, is not in a position to regulate the reserves of the banking system. Unless there is a deliberate decision to convert the Exchange Fund to a Central Bank by requiring the banks and DTC's to place deposits with the Fund, and to require banks to maintain such deposits at a minimum ratio to deposit liabilities, it follows that this approach to regulating monetary growth in Hong Kong is not feasible.

(2) Quantitative Ceilings on Bank Assets and Liabilities

Monetary control via quantitative ceilings on Bank Assets and Liabilities has been tried in many countries and rejected. They distort credit flows throughout the economy, they encourage funds to be channelled through other non-bank institutions, and they thereby encourage disrespect for the law. Money being fungible, it will in any case almost invariably find a way round such short-sighted controls.

There has, fortunately, been no serious consideration of this approach to monetary policy for Hong Kong. Even if it were feasible in Hong Kong's fluid capital markets - which I doubt - there is plenty of evidence to suggest that such an approach would be highly undesirable. Indeed this is why such ceilings have in the past year or so been abandoned by the Bank of England.

(B) Indirect Methods of Money Supply Control

Before I tackle the question of interest rates or exchange rates as an indirect method of regulating monetary growth, let me preface my statement by saying that I believe that it is important in government and in business and in private life for individuals or institutions to do or try to do only that which is within their power to do. If governments attempt the impossible, they rapidly lose credibility; if individuals or institutions attempt the impossible not only do they soon begin to look foolish, but they frequently end up in the bankruptcy courts.

(1) Setting Interest Rates

In an orthodox central bank system, the raising of interest rates by the monetary authorities to curb money or credit growth is part and parcel of the process of restricting the growth of bank reserves. The two are inseparable. It would not make sense for a central bank to raise the discount rate and yet continue to conduct open market operations at rates well below the discount rate or at progressively lower rates; the sensible thing to do is to raise the discount rate and then to sell assets (e.g. by conducting open market operations) so as to reduce available reserves until market yields rise close to the discount rate. Thus the restriction of reserves and the raising of interest rates go hand in hand in an orthodox system. But in Hong Kong there is no such link. The Exchange Fund does not control bank reserves in the conventional sense, and more than that it does not control any particular interest rate. So raising interest rates in Hong Kong does not restrict the supply of reserves or the ability of the banks to create credit. Therefore the first objection to interest rates as a weapon of monetary control in Hong Kong is that the mechanisms for making interest rates effective do not exist. In this sense I regard the interest rate option as not feasible.

Recently the Hong Kong authorities have leaned on the Licensed Banks through the Hong Kong Association of Banks (HKAB), and have attempted to cajole them into raising or lowering (usually raising) interest rates. This undignified procedure has produced anomalies in the market place, and wherever such artificial manipulation has been tried it has been found to be a most unreliable method of regulating either the demand for credit or the supply of money. Yet much of the new banking legislation in Hong Kong is predicated

LIQUID ASSETS, RESERVES, AND "RESPONSIBLE" BANKING

Liquid assets are a prudential device designed to ensure good banking, not good monetary policy. The problem with liquid assets is that they fail to ensure good banking and they are liable to obstruct good monetary policy.

- (1) In a perfect world the ideal bank would match the maturity of its assets with the maturity of its liabilities. But in the real world the profit motive drives banks to deviate from this high standard, placing their depositors at risk. Liquid asset ratios were therefore devised to ensure that banks held at least a certain minimum proportion of their deposit liabilities in the form of readily marketable assets to meet any potential call on their deposit liabilities by customers. These ratios (a) distort the demand for credit instruments, and (b) they offer poor protection for depositors. As Dr. Jao has pointed out in his book, 'Currency and Banking in Hong Kong' the introduction of the Liquid Asset system via enactment of the 1964 Banking Ordinance did not stop the 1965 Banking Crisis.
- (2) In a perfect world bank reserves would grow at exactly the right rate necessary to ensure the appropriate growth of the money supply. But Liquid Assets are not reserves. In Hong Kong (and elsewhere) Liquid Assets are defined to include:
 - (i) domestic currency liabilities of the authorities (notes, coin),
 - (ii) liabilities of the government (government debt and other government-guaranteed instruments),
 - (iii) liabilities of other banks,
 - (iv) certain domestic currency liabilities of the non-bank public, and
 - (v) foreign exchange.

Of all these assets, the only ones which are subject to the direct control of the monetary authority are the liabilities of the Hong Kong monetary authority itself: namely notes (Certificates of Indebtedness at one remove) and coin. The others are credit instruments issued by other organisations beyond the control of the monetary authority. As long as banks hold some notes and coin, but lend or invest the remainder of their assets with the public, the only lever the authorities have over the size of bank balance sheets is through the ratio of deposits to notes and coin held by the banks. That is why in the deposit multiplier of the banking system (D/R), reserves R (which are a component of high-powered money) should be defined as liabilities of the monetary authority i.e. notes and coin in Hong Kong. The size of the bank credit multiplier or credit expansion factor is a function of D/R , not a function of the Deposits to Liquid Assets ratio.

In any banking system which has Liquid Asset ratios the quantity of liquid assets will grow at a rate which clearly depends on variety of factors beyond the control of the monetary authority. For example, in Britain, Australia, South Africa and Canada, an increase in the government budget deficit and hence Treasury Bills or short-term government securities leads to an increase in the quantity of Liquid Assets available. In Hong Kong a decision of the banks to acquire foreign currency assets also increases Liquid Assets. In Britain the borrowing of funds by the London Discount Houses from the clearing banks and the issue of short-term debt by Local Authorities both increase Liquid Assets.

There is thus no necessary relation between the rate of growth of reserves and the rate of growth of Liquid Assets. The problem is that when a Monetary Authority focuses on the ratio of liquid assets to deposits, rather than the rate of growth of liquid assets, and subsequently supplies reserves to maintain a particular interest rate target or to maintain an exchange rate target, this invariably results in erratic money growth - sometimes too rapid and sometimes too slow.

In Hong Kong there used to be an exchange rate "target" i.e. a fixed exchange rate, which meant that the Exchange Fund supplied or withdrew any amount of currency (or CIs) bid or offered at one price. Hong Kong's money supply therefore fluctuated with the balance of payments, sometimes growing more rapidly and producing mild inflation, but then reverting to a slower pace so that inflation moderated. Today the exchange rate is floating, so the money supply no longer fluctuates for balance of payments reasons.

Instead a cartel of banks (the Hong Kong Association of Banks) sets (obligatory) deposit interest rates and (recommended) loan rates at some margin above that. What is the connection between interest rates and the money supply? First, there is a clear tendency for the banks to ensure the loan rate is set low enough to keep the demand for bank credit strong, i.e. to ensure that bank assets continue to grow rapidly. Deposits grow at a roughly corresponding pace, and when the demand for banknotes subsequently increases as spending rises the banks pay the Exchange Fund in HK\$, receive a HK\$ deposit in exchange, so the new notes cost nothing i.e. the Exchange Fund is passively supplying currency, irrespective of the going rate of interest.

The only exceptions to this tendency for interest rates to be persistently too low appear to be when the HK\$ depreciates sharply and, under pressure from the authorities, the HKAB raises its interest rates abruptly. For a time the demand for credit abates. Before long, however, competitive pressures undermine the agreed rates (recently under the enchantingly deceptive guise of preferential rates for deserving borrowers) and, rather than lose market share, the banks meet again to discuss lowering the rate structure. Once more credit demands pick up, a new round of credit expansion and monetary acceleration get under way, until eventually the battered HK\$ tumbles yet again, and the whole cycle repeats itself.

There is therefore a fundamental contradiction at the heart of Hong Kong's monetary system: the expectation by policy-makers that banks will serve the public interest by keeping monetary growth low, while at the same time serving the interest of their shareholders by expanding their assets (and hence their deposit liabilities and the money supply) at as rapid a pace as is compatible with prudence and profitability.

Banks should serve their loan customers, their depositors and their shareholders. They should not be expected to serve the general good. The doctrine of public responsibility in this sense advocated by Sir Philip Haddon-Cave, by Peter Allsopp, and now by John Bremridge is fundamentally unsound. In a city which above all others in the world is a tribute to the marvels of the free enterprise system it is almost incredible to hear high public officials expound this view. They surely do not believe in it at heart. Sir Philip himself was one of the most cogent advocates of the free market system under a banner which he liked to call "positive non-interventionism". What can be the explanation for this paradoxical stance?

The only explanation we can offer is that these public officials must have been driven to this argument by frustration. As explained in AMM Vol. 5 No. 4, under present institutional arrangements the authorities are not able to do anything about excess monetary growth and excess credit-creation by intervention in the foreign exchange market or in the domestic money markets via the standard multiple expansion or contraction process. Accordingly, they have resorted to phrases like the need for banks to be "responsible", or the desirability of "self-regulation" in an attempt to achieve some influence or moral suasion over the banking system.

The banks are not to be blamed for the present situation. Nor are some of the public officials currently in office. We believe these conflicts to be the inevitable outcome of the strange series of developments in Hong Kong's banking system in the early 1970s, the principles of which we described in the July/August issue of AMM. The contradictory public statements - and the incessant spiralling of credit - will only cease when the Exchange Fund which is at the heart of monetary system is restored to its proper role in the monetary system. Under the Exchange Fund Ordinance of 1935 that role was "for the purpose of regulating the exchange value of the currency of Hong Kong", a clause which despite many revisions to the Ordinance has remained unchanged to this day. Ironically, the innovations of 1972-74 directly undermined the ability of the Exchange Fund to perform this role, and the new policy of overt intervention in the foreign exchange market did not have the multiple expansionary and contractionary effects which orthodox central banks command through intervention. In our view it would be far better to reverse the innovations of 1972-74 than to tamper continuously with the banking structure whilst at the same time blaming the banks for a situation which is not of their own making.

on the assumption that the authorities' influence over the HKAB's interest rate structure will be effective in these respects. In addition the new legislation is highly discriminatory vis-a-vis small depositors, and it is evidently producing much dissatisfaction among, for example, registered DTCs. Therefore a second fundamental objection to official manipulation of interest rates and the associated new banking structure is that competition is restricted among three compartmentalised sections of the financial system, and this is undesirable both from the standpoint of the registered DTCs who have hitherto served the public well as highly competitive intermediaries, and from the standpoint of depositors.

For these reasons I believe the setting of interest rates and hence the present system in Hong Kong to be both undesirable and ultimately unworkable.

(2) Setting the Exchange Rate

Setting the exchange rate is an indirect method of regulating the money supply because it leaves the quantity of bank reserves and/or the creation of credit and hence the money supply to be determined by the balance of payments.

This is the method used by many smaller economies (Malta, New Zealand, Singapore, Seychelles) and some larger economies (Austria, Australia, Malaysia, Sweden).

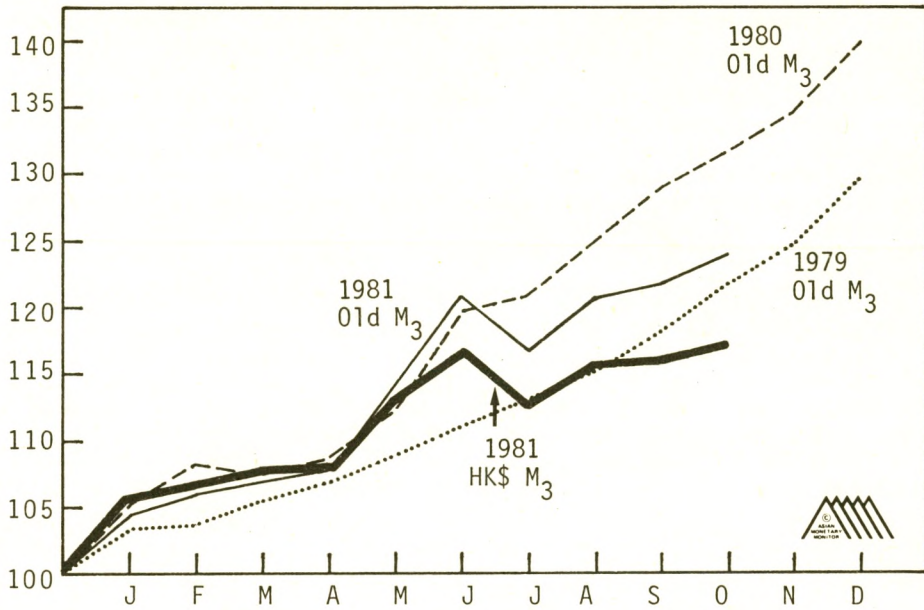
This approach has been adopted both in countries which have central banks (and in these cases the central bank intervenes in the market) and in economies like Hong Kong which do not have central banks (where the monetary authority does not have to intervene).

In either case the system operates through the balance of payments: when there is a balance of payments surplus and the country is "earning its way" in the world, the money supply can grow or accelerate, while a balance of payments deficit will restrict the ability of the money supply to grow, and even cause it to decline, until equilibrium is restored and the country is once again "earning its way".

Under this system the growth of the money supply is in effect regulated by the state of the balance of payments. In time interest rates, economic activity, and the level of prices will all be affected by the monetary growth stemming from the overall external balance. The advantage of setting the exchange rate over setting interest rates is twofold. First, setting the exchange rate permits maximum use of market forces in all markets (except the foreign exchange market itself), while providing an automatic mechanism for tying the money supply growth and hence the price level and inflation in the domestic economy to the trends in these variables elsewhere. Second, in the context of Hong Kong, setting the exchange rate is something which

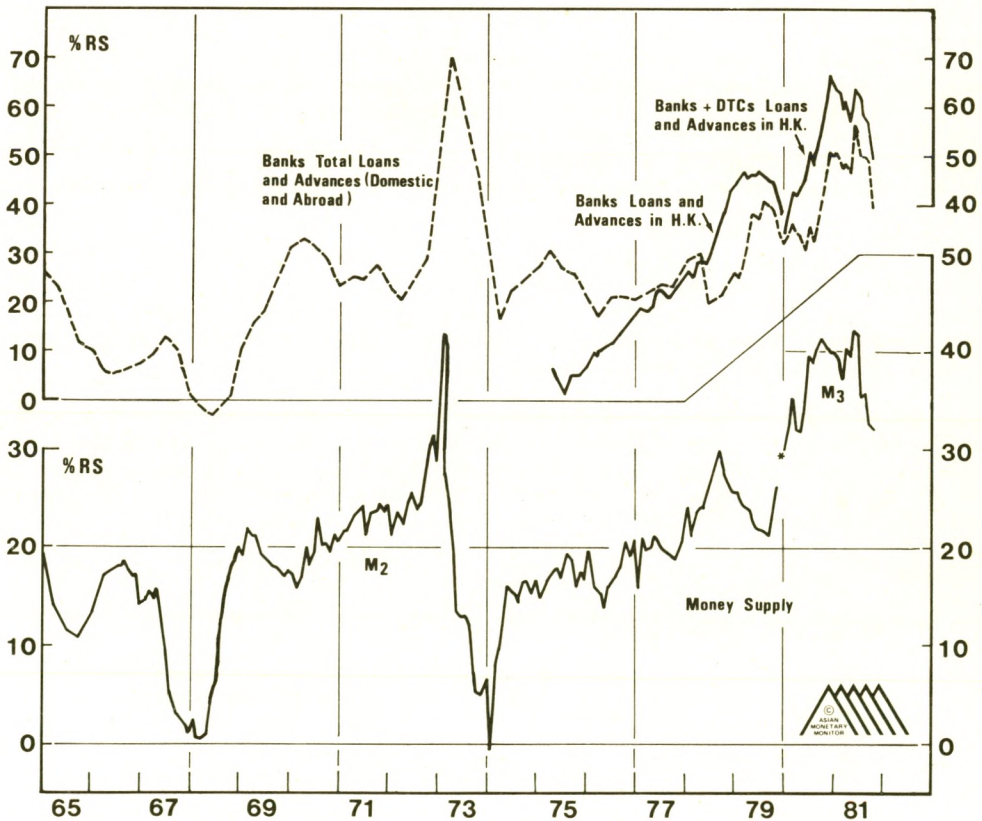
HONG KONG:CHART 1

INDEX OF HONG KONG MONEY SUPPLY (Dec.=100)



HONG KONG

CHART 2 : MONEY AND CREDIT GROWTH



*Change of M_2 to M_3 series

PEGGING THE EXCHANGE RATE DOES NOT REQUIRE INTERVENTION

In the good old days before the War when Hong Kong dollars were convertible to sterling at a fixed rate, the Hong Kong dollar and the pound sterling were essentially different denominations of gold (from 1935), freely convertible into one another.

After the War ordinary members of the public were denied the right to convert sterling into gold, and, unfortunately for Britons, they were also prevented by foreign exchange controls from converting sterling into Hong Kong dollars. However, the citizens of Hong Kong - whose economic freedoms were taken more seriously by their benevolent administrators - were permitted freely to convert Hong Kong dollars into sterling. So despite the changed circumstances of the post-war world it was still possible to say that a Hong Kong dollar was simply a different denomination of sterling circulating in a distant corner of the empire.

The guaranteed purchasing power of the HK\$ in terms of sterling was underwritten by the willingness of the Exchange Fund to buy and sell Hong Kong dollars (or the rights to issue Hong Kong dollar notes) at a fixed price in sterling. Just as the Bank of Scotland underwrote the equivalence of Scottish pounds and British pounds, so the Exchange Fund effectively guaranteed the equivalence of HK\$16.00 and one pound sterling. But neither the Bank of Scotland nor the Hong Kong Exchange Fund had to intervene in the money market or foreign exchange market in the normal course of events to achieve this equivalence.

How was this possible?

In essence it worked like this: The Exchange Fund promised to buy or sell any amount of sterling at a certain stated price, which, for historical reasons, happened to be HK\$16. But it was only willing to supply notes (or the rights to issue notes) to two or three commercial banks in Hong Kong. The guarantee of equivalence between HK\$16 and £1 can be expressed as follows:

$$\begin{array}{cc} \text{HK\$16} & = & \text{£1} \\ \text{(Notes)} & & \text{(Notes)} \end{array}$$

Now it happens that in each country there was a slightly different banking system with different habits of settlement, different levels of economic development, different patterns of seasonal fluctuation etc. etc. and the total quantity of notes in Hong Kong (HK\$ Q) was different from the total number of notes in Britain (£P). Similarly there was a different quantity of deposits in each country, HK\$ Q' and £P'. Nevertheless there was in each country a fairly stable ratio of deposits to the note issue.

$$\begin{array}{lcl} \text{So,} & \text{HK money supply} & = Q + Q' \\ \text{and} & \text{UK money supply} & = P + P' \end{array}$$

Hong Kong deposits Q' were of course convertible into currency P and British deposits P' were naturally convertible into currency Q.

So long as individuals or banks in both countries could convert deposits to currency and the Exchange Fund was willing to issue CIs (or notes) for sterling, it followed logically that deposits in either currency would be convertible into deposits in the other currency. In other words, not only were HK\$ notes made equivalent to sterling, but HK\$ deposits were virtually equivalent too.

Schematically:

$$\begin{array}{lcl} \text{Because} & \text{HK money supply} & = Q + Q' \\ & & \text{convertible} \\ & & \longleftrightarrow \\ \text{and} & & \updownarrow \text{convertible (for note issuing banks)} \\ & & \text{at Exchange Fund offered rate} \\ & \text{UK money supply} & = P + P' \\ & & \longleftrightarrow \\ \text{We have} & \text{HK money supply} & = Q + Q' \\ & & \text{convertible} \\ & & \updownarrow \text{convertible} \\ & \text{UK money supply} & = P + P' \end{array} \quad \begin{array}{c} \text{(all convertible)} \end{array}$$

Now in practice several kinds of currency conversion transactions used to take place. First, people used to transmit funds from deposit accounts in Hong Kong to Britain (or vice versa) telegraphically. Aside from the cost of the cable this form of remittance was very efficient and only involved a few book-keeping entries so these telegraphic transfer "T.T." rates were very "fine" - that is they were highly competitive.

Next there were those who travelled between Britain and Hong Kong and wanted to use sterling travellers cheques as a form of safekeeping. Whenever sterling travellers cheques were cashed in Hong Kong this would require not only a few book-keeping entries, but a teller would have to check the identity of the person cashing the cheques, some forms would have to be filled in, and eventually the used cheques would have to be mailed back to England. Naturally all this processing was costly and therefore merited a slightly less fine rate than the T.T. rate to compensate the banks for the work involved.

Finally there were some people who carried sterling notes to the other side of the globe and asked to convert these notes into HK\$ cash locally. Again this involved money changers or banks in some administrative work, and it usually meant the bank in question holding quite a pile of notes as inventory ready for the next person who happened to come in off the street wanting to buy sterling. To cover the cost of carrying this inventory, and to defray the costs of handling the cash at the tellers window the Hong Kong banks charged another rate for sterling notes, different from either the rate offered for telegraphic transfers, or from the travellers cheque rate.

Similarly, none of these rates was quite the same as the rate offered by the Exchange Fund. All three "market rates" varied above or below the Exchange Fund rate, depending on the overall state of supply and demand. They were all quite separate "markets" for different forms of the same commodity (money).

In effect, the joint conditions of one-to-one convertibility of currency into deposits (and vice versa) in each currency together with the willingness of the Exchange Fund to issue or redeem notes (or CIs) for sterling at a fixed rate meant that money (cash or deposits) in Hong Kong was "equivalent" in value to money in the UK, with only some marginal differences due to the type of exchange transaction. The crux of this equivalence was the open-ended willingness of the Exchange Fund to issue or redeem Certificates of Indebtedness (i.e. notes) at a fixed price. By making Hong Kong dollar notes equivalent to a certain amount of sterling (notes or deposits), the Exchange Fund effectively made any component of the Hong Kong money supply - notes or deposits - "equivalent" to sterling.

Provided the Hong Kong authorities had been willing to maintain this equivalence of Hong Kong dollar notes for sterling, there is no reason why the old automatic adjustment mechanism should not have continued to work. The Exchange Fund could have stayed out of the three foreign exchange "markets" - or indeed any others - and the money supply and the price level in Hong Kong would have adjusted to whatever was necessary to keep the overall balance of payments in equilibrium.

In fact the Hong Kong authorities chose to alter the mechanism in 1972 first by accepting HK\$ against the issue of Certificates of Indebtedness (instead of sterling or any other foreign currency), and second by deliberately intervening in the foreign exchange markets via some accounts which they set up with the licensed banks in Hong Kong. Things have never been the same since.....

the Exchange Fund can actually do - it is not beyond the power of the authorities to set a rate and to maintain it. However, one must be extremely careful to specify what rate the Exchange Fund can set and how it could do it because generalised intervention in the regular commercial market for foreign exchange as practised in the 1970's clearly has not been effective, nor should it have been expected to be effective.

Historically, as you all know, the Hong Kong government set the exchange rate of the HK\$ against sterling. But let me emphasise that unlike a central bank, colonial currency boards such as the Hong Kong authorities did not have to intervene in the foreign exchange market. What they did was to set the price of Certificates of Indebtedness or CIs in terms of one single currency (Sterling). Other market rates - the TT rate, the rate for travellers cheques and banknotes etc. - all fluctuated in a narrow range around the Exchange Fund's rate or price for CIs. (The mechanism for this classical system is explained in the box on pp. 24-25.)

That system was fine for a world of generally rigid exchange rates, and it worked well to keep Hong Kong's money growth and hence prices in line with its chief competitors. But clearly we are no longer in such a world. The world today is a world of floating exchange rates, and it probably is not desirable to peg the Hong Kong dollar rigidly to any single currency.

The best solution, I believe, would be for the Exchange Fund to set the price of CIs in terms of a basket of other currencies. For example they could announce that to acquire the equivalent of HK\$100.00 in Certificates of Indebtedness, the note issuing banks should pay, in any foreign currency, the equivalent of (say):

		Approx. value in HK\$
	US\$5.00	28.00
plus	DM10.00	25.00
plus	£ 2.00	22.00
plus	Yen 1000	25.00
		HK\$100.00

Note that the Exchange Fund would not have to intervene in the foreign exchange market, nor it would have to worry about interest rates. Moreover the money supply could once again be indirectly determined via the balance of payments.

In the long term Hong Kong's inflation rate would approximate to a composite of the inflation rates in the economies of these four major currencies. The particular

(cont'd on p. 28)

SETTING THE RECORD STRAIGHT

The article about Hong Kong in the July-August issue of AMM entitled "Time to Blow the Whistle" produced quite distinct reactions from different quarters.

From the academic side we received several letters of commendation, and none expressing any fundamental disagreement. We take this response as particularly heartening and read it as an endorsement of our analysis of the fundamental principles on which the Hong Kong banking system now operates following the changes of the 1970s.

From the official side we were cautioned about certain factual errors in the text of the article, but again there was no demonstration that the principles were incorrect. The errors of fact to be corrected are as follows:

AMM Vol. 5 No. 4

page 21 "Starting in June 1972 the external value of the HK\$ was unpegged from sterling and pegged to the US\$. In other words the Exchange Fund no longer issued CIs at a price quoted in sterling, but quoted a price in US\$."

The first sentence is correct. The second sentence is incorrect. When the HK\$ was unpegged from sterling and pegged to the US\$, the Exchange Fund began to accept payment for Certificates of Indebtedness in local currency, so although the authorities were trying to peg the rate they undermined the convertibility principle set out on pp. 24-25 of the current issue.

page 22 The Exchange Fund "borrowed Hong Kong dollars from the commercial banks".

This statement was made on the basis of discussions with commercial bankers in Hong Kong, but it is denied by the Secretary for Monetary Affairs. Even if it is not true it does not affect the principles set out on pp. 28-29 of the July/August issue.

page 22 "the assets of the Exchange Fund were now well in excess of the minimum 105% cover required to guarantee the note issue."

What the Exchange Fund Ordinance actually states is that money cannot be transferred to other government accounts unless the assets of the Exchange Fund are in excess of 105% of its liabilities, so there is no legal minimum though it was clearly the intention of the framers of this Ordinance that the assets of the Fund should not be allowed to fall below 105% of its liabilities. It is standard practice in most countries for central banks to transfer the profits or seignorage from the note issue to the government. The purpose of the Hong Kong rule was to prevent the government from raiding the "monetary" assets of the Exchange Fund for "fiscal" purposes.

* * * * *

It has also been pointed out to us in reference to our article "Hong Kong: The New Monetary Statistics" in the September/October issue of AMM that although it is planned not to publish the monthly consolidated Licensed Bank and DTC statistics in their old format after the December 1981 returns, the quarterly data previously collected by the Commissioner of Banking giving a sectoral analysis of loans and advances will be supplied to the Secretary for Monetary Affairs from December 1981. The new analysis will provide some new detail: it will retain the currency split (HK\$ and total of all currencies) used in the new monthly returns. This is good news.

combination of currencies chosen for the currency basket above implies a roughly equal weighting for each of the four currencies, but there is no special rationale for this choice, and other currency combinations would be entirely feasible. The important point to remember is that the choice of currencies in which to express the price of Certificates of Indebtedness implies a choice of inflation rates: the stronger the currencies selected, the lower the rate of inflation in Hong Kong. Conversely, the weaker the currencies against which the Exchange Fund prices its CIs (i.e. banknotes at one remove), the higher the rate of inflation will be in Hong Kong.

In the foreign exchange markets arbitrage would keep the T.T. rate for HK\$ within a quite small range on either side of the Exchange Fund's designated rates for CIs. Arbitrage by the banks and by dealers would support the Exchange Fund's set rates for CIs, and help to eliminate the need for explicit intervention in the foreign exchange market.

In the domestic money markets Hong Kong could reverse the regrettable trend of recent years towards officially sanctioned interest rates and move towards a completely free market for loans and deposits. With every major financial centre in the world moving towards freer interest rates, it clearly makes sense for banks and DTCs to be able to vary the price they charge for their loans according to their cost of funds. This is especially so with foreign exchange rates varying on a day-to-day basis. The market pricing of loans and deposits has been the main innovation in Hong Kong's money markets in the past decade or so, and it is mainly thanks to the DTCs which have been outside the quasi-official banking cartels. If the proposals suggested here were to be adopted, the out-moded Interest Rate Agreement could gradually fade into the obsolescence which it deserves, and with it the artificial three-tier compartmentalisation of Hong Kong's banks and DTCs would come to be seen as a misguided attempt to tackle a problem which could be better solved by another approach.

In short, the proposal that the Exchange Fund should define and (in effect) regulate "the exchange value of the currency of Hong Kong" in terms of a basket of other foreign currencies is not only feasible but, in my view, highly desirable. In essence it amounts to a simple updating of the Exchange Fund's traditional (pre-1972) role; instead of setting the price of the HK\$ in terms of one single currency, it means setting the price in terms of a basket of currencies which is more in conformity with Hong Kong's role as an international centre for manufacturing, trade, and finance.

Until this solution is adopted I believe that Hong Kong will continue to experience monetary instability with a bias towards excess monetary growth and currency weakness, all of which are reflected in the recent condition of high interest rates. High interest rates, in other words, are a symptom of our present difficulties. High interest rates or indeed interest rates alone are not in themselves any solution to our problems.

JAPAN

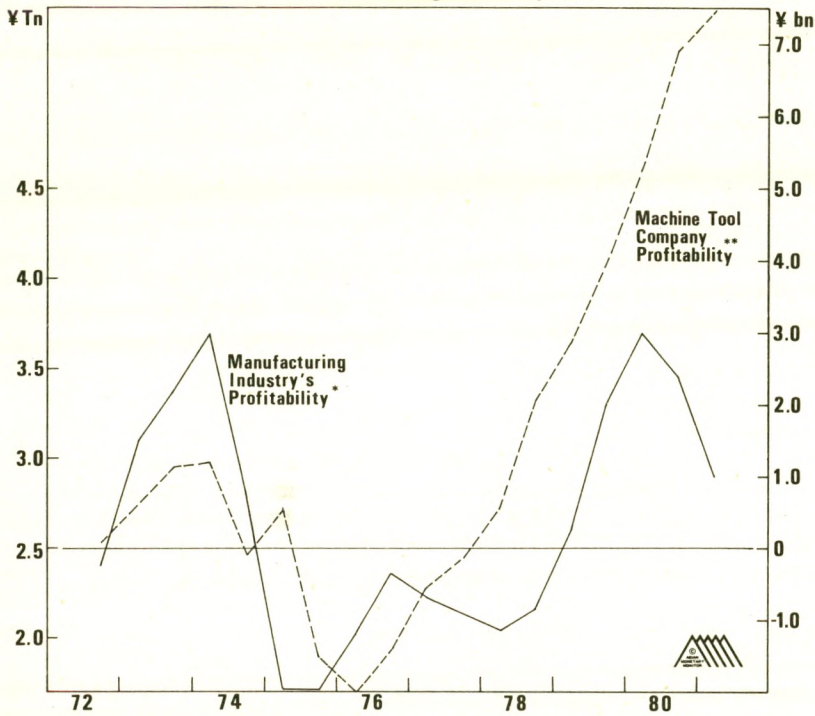
CAPITAL INVESTMENT THROUGH THE BUSINESS CYCLE

In any economy, the capital goods sector is usually thought of as the sector whose profitability is most subject to the influences of economic cycles. In the past the Japanese capital goods sector has been no exception to this general rule, and the profits of many Japanese capital goods companies are still heavily influenced by cyclical trends in the domestic economy. Therefore, the trends evident on Chart 1 need some explanation. The chart illustrates the relationship, over the years 1972 to 1981, between the operating profits of Japanese manufacturing industry as a whole (deflated by the GNE deflator) and the real profits of the five major Japanese machine tool producers. It can be seen at a glance that the two series follow a roughly similar pattern up until 1977, when machine tool profitability took off, a growth which has continued since. This article attempts to analyse the relationships inherent in Japanese economic cycles, the change in these relationships that has occurred since 1976/77, and the implications of this change for the capital goods industry.

An important determinant upon the profitability of the Japanese capital goods industry is the level of new orders for machinery coming from domestic manufacturing industry. Domestic new orders for machinery have followed and still do follow a highly cyclical pattern. This may be surprising, as since 1976, when the effects of the Bank of Japan's strict attention to the control of monetary growth became evident, the rate of growth of real GNP has been remarkably stable. However, despite the stability of the overall aggregate, the constituent components i.e. investment, consumption, the balance of trade and government expenditure, have shown a high degree of cyclicalities. Chart 2 shows the growth of private gross fixed capital formation (not including housing) relative to the growth of gross national expenditure (i.e. it measures private GFCF-GNE growth deflated) and compares this series with the rate of growth of new orders for machinery from domestic manufacturing industry. It can be seen that both series follow the same cyclical pattern. This is to be expected as both are almost different ways of measuring the same thing.

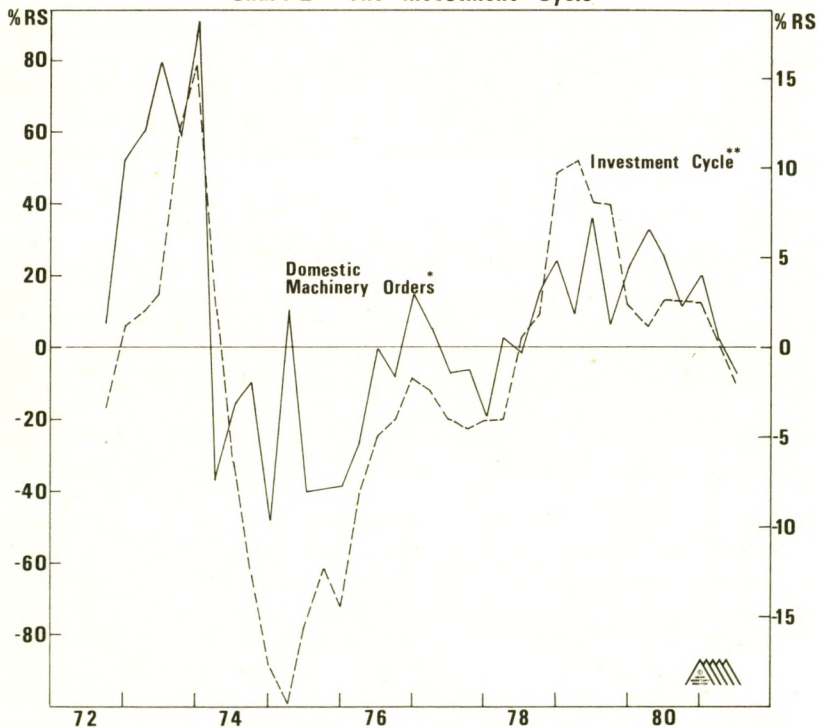
It might be thought initially that as the growth of the Japanese economy has been, to a large degree, export led, investment booms should be the result of export booms i.e. a cyclical peak in export growth perhaps due to high overseas demand or relative weakness of the yen would mean a high level of demand and production in the economy and hence a high level of planned investment by manufacturing industry. However, Chart 4 demonstrates that this has clearly not been the case since 1977. The chart compares export growth relative to GNE growth (i.e. export growth - GNE growth (both deflated)) with private investment growth relative to GNE growth (i.e. non residential private gross fixed capital formation growth minus GNE growth (both deflated)). It can be clearly seen that since

JAPAN
Chart 1 : Manufacturing Industry Profits



*Manufacturing industry's operating profits (1970 prices)
**Profits of five leading machine tool producers (1970 prices)

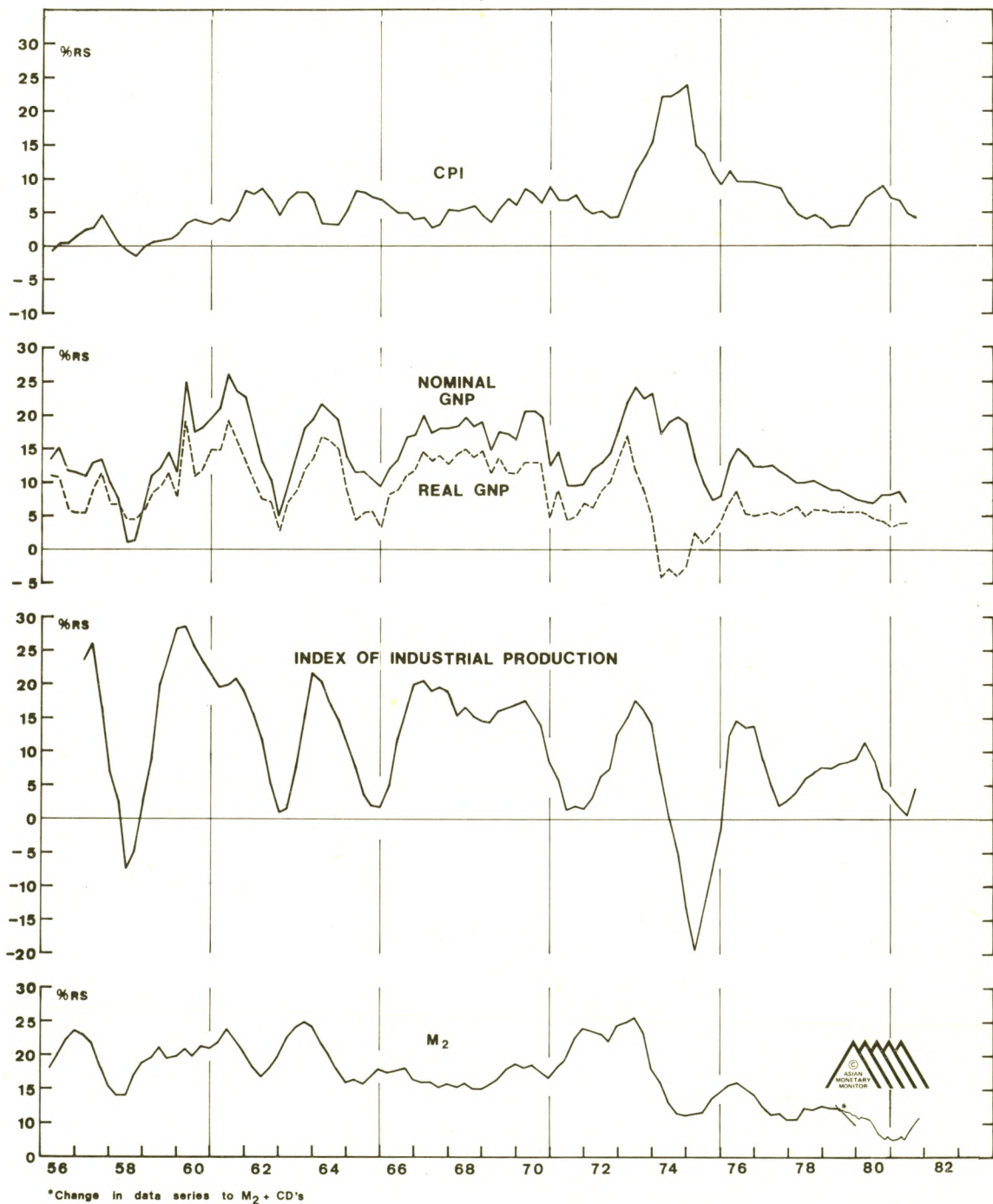
JAPAN
Chart 2 : The Investment Cycle



*New orders for machinery from domestic manufacturing industry (inflation adjusted)
**Real non-residential private gross fixed capital formation growth minus real GNE growth

JAPAN

CHART 3: MONEY, OUTPUT AND PRICES



1977 peaks in one series have corresponded with troughs in the other series and vice-versa. As GNE growth itself has remained stable since 1977, this implies that exports have either crowded out domestic investment or investment has crowded out exports. This can be explained simply from the identity:

$$Y = C + I + G + X - M$$

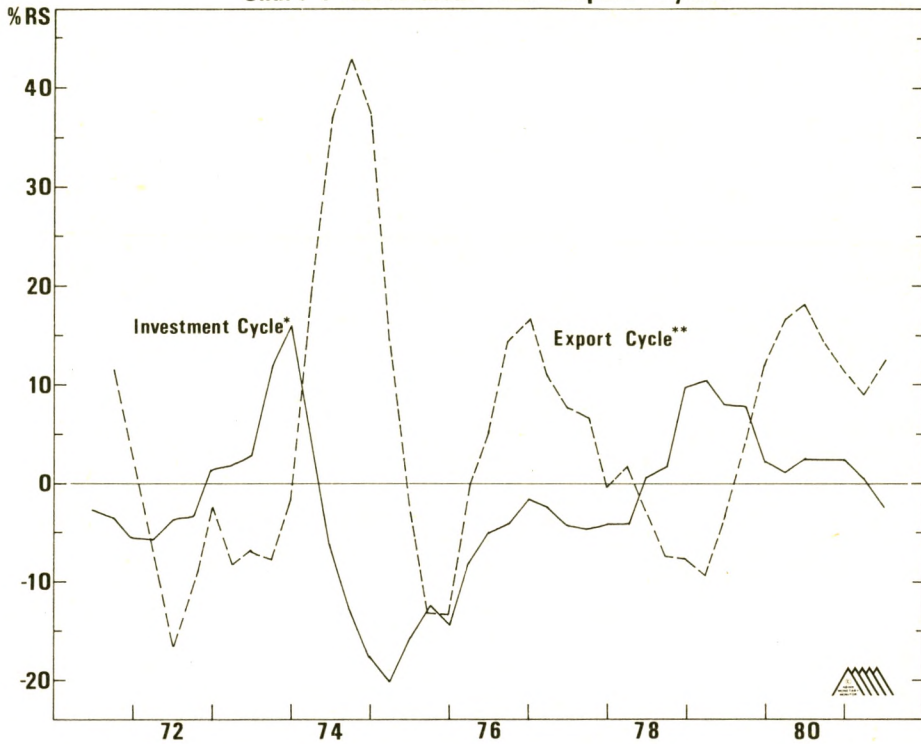
where : Y is national income
 C is consumption
 I is investment
 G is government expenditure
 X is exports of goods and services
 M is imports of goods and services

If we look at this in terms of rates of change and assume G has been roughly stable, then $\Delta Y = \Delta C + \Delta I + \Delta(X - M)$, and as ΔY has been constant due to monetary growth being held constant, and velocity being unchanged, an improvement in $\Delta(X - M)$ must be matched by either a decrease in ΔC or a decrease in ΔI and vice-versa. This relationship did not hold before 1977, because at that time the growth of national income was not held constant by monetary control. At that time we might have expected a more 'Keynesian' relationship to be evident as monetary growth would have been accommodating. Thus, an upswing in investment would have meant an increase in monetary growth and gross national product, and initially an increase in both exports and imports, or, alternatively, an improvement in the balance of payments would have meant a monetary inflow and an increase in national income and hence investment.* Thus, briefly, the export cycle and investment cycle would have tended to move roughly together. This seems a close approximation to what happened in the economy before 1977.

However, after 1977, the mechanism by which exports might have crowded out investment is not at all obvious. One possible transmission mechanism could be a movement in real yields, or interest rates. One can view this in either of two ways: an increase in export growth would impart an upward stimulus to national income growth - but income growth is constrained by constant monetary growth. Hence, a tightening of liquidity would result in a rise in real interest rates until an equivalent amount of planned investment or consumption had been 'choked off'. Alternatively, one can view this from a flow of funds viewpoint. The rest of the world's net acquisition

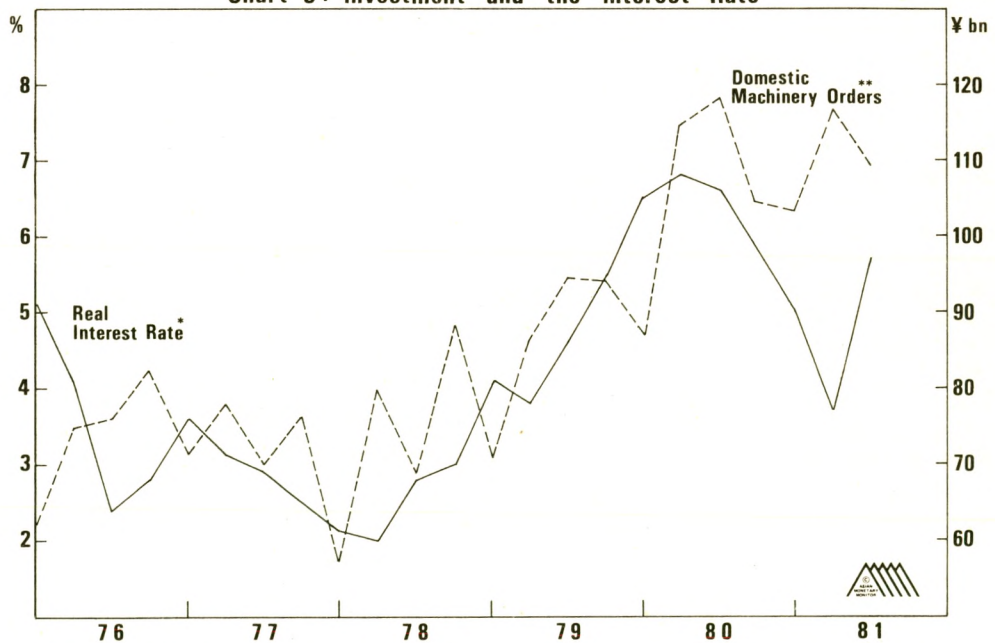
* Even if investment growth was entirely dependent upon export growth then we might still expect to see the investment growth cycle lead the export growth cycle. This is because it will be the absolute level of investment rather than its rate of growth, which will tend to depend upon the rate of export growth. Hence the peak in the export growth cycle should correspond with the point at which the investment growth cycle crosses the time axis in the downswing i.e. the point at which the level of investment is at its maximum. This is an example of the simple accelerator theory which is discussed later.

JAPAN
Chart 4 : Investment and Export Cycles



*Real non-residential private gross fixed capital formation growth
minus real GNE growth
**Real export growth minus real GNE growth

JAPAN
Chart 5 : Investment and the Interest Rate



*Long term prime rate of interest minus GNE deflator
**New orders for machinery from domestic manufacturing industry
(annualised, 1972 prices)

of financial assets + the corporate sector's net acquisition of financial assets + the personal sector's net acquisition of financial assets + the government sector's net acquisition of financial assets must equal zero. An increase in the balance of payments surplus means a reduction in the rest of the world's net acquisition of financial assets and if the government sector's net acquisition is to remain constant, then either the corporate or personal sector's net acquisition of financial assets must increase. If monetary growth and hence national income growth are to remain constant then either investment growth must drop, or the personal sector's savings must increase i.e. consumption must drop. An increase in the yield on financial assets relative to the yield on real assets i.e. an increase in real interest rates could bring about either of these two consequences.

However, a look at Chart 5 reveals that this explanation does not hold good. The chart compares real (i.e. deflated) domestic manufacturing machinery orders with real rates of interest (i.e. long term prime rate minus the GNE deflator) over the period 1976 to 1981. The graph reveals a close positive relationship between domestic orders for new machinery by manufacturing industry and real interest rates, with interest rates lagging orders by one quarter. This does not support the view that exports have crowded out investment but instead is compatible with an investment cycle which has crowded out exports i.e. domestic investment booms have diverted the resources of capital goods producers and their suppliers away from exports to the home market, and shifted national income from retained profits to wages and hence promoted a domestic consumption boom which has further shifted resources to the home market and hence further crowded out exports.

Thus the cyclical trend in real interest rates moves with, although lagging slightly, the trend in investment. This is consistent with constant monetary growth and hence interest rates which are purely demand, rather than supply, determined. In the downswing of the investment cycle, the demand for credit for investment and hence interest rates, drops and the downward momentum of interest rates continues until yields on financial assets become less than expected yields from investment in capital goods. At this stage investment is stimulated, the domestic economy and consumption recover, and later interest rates begin to rise again as the demand for credit picks up.

However, there is no reason for this sequence of events always to occur like this. In fact, there is a good case for suggesting that the order of events has been reversed this year. In 1981, Japan has had an export boom stimulated independently by the weakness of the yen, itself the result of high US interest rates and a strong US economy. In Japan, real interest rates have been historically high and rising because, although nominal rates have fallen throughout the year, inflation has been falling more quickly. Therefore, this year we have seen an export boom, which, in conjunction with roughly stable national income growth, has resulted in an increase in real yields and the cost of credit, and hence a decrease in consumption and investment growth.

If there is an investment cycle, then what are its main determinants? There are close correlations between real domestic manufacturing machinery orders and capacity utilisation in manufacturing industry, real operating profits of domestic manufacturing industry, manufacturing industry's production and the rate of growth of GNE. Charts 6 and 7 offer a good explanation of the rate of growth of manufacturing industry's orders for new machinery in terms of manufacturing industry's index of capacity utilisation and the rate of acceleration of GNE. This is what might be expected from a simple accelerator theory of investment, if GNE growth is taken as a proxy for the rate of growth of demand in the economy.

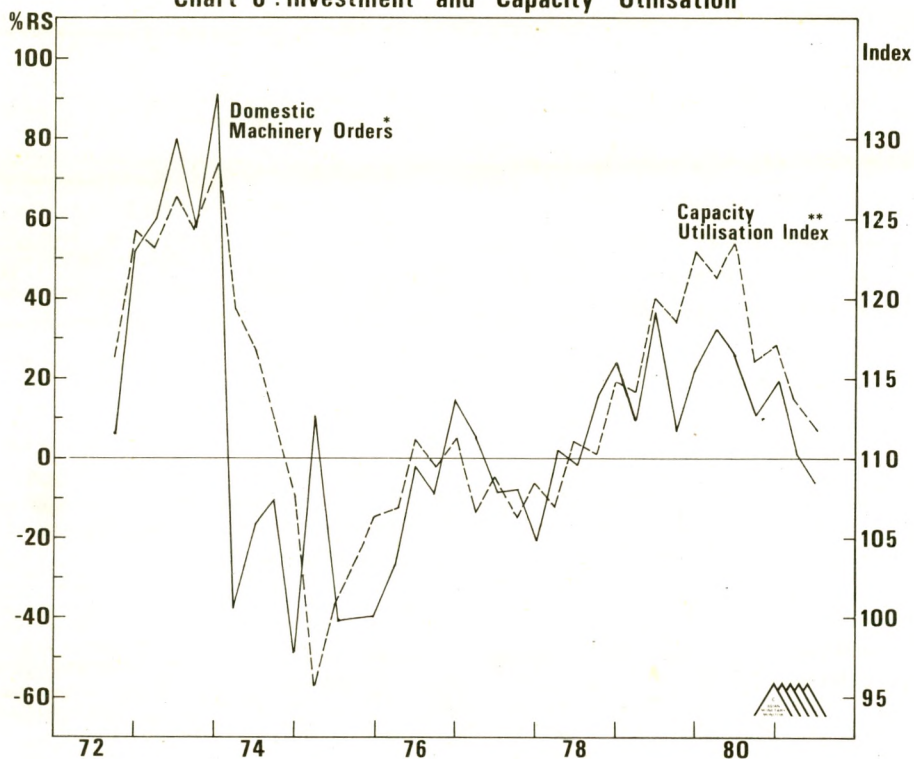
An example of the simple accelerator theory might run as follows: if there are 10 machines, each with an average life of 10 years, producing 100 units of output, then on average, 1 machine will need replacing each year i.e. orders for machinery equals 1. If in the following year, the demand for the product then grows by 10%, 1 extra machine will be needed to satisfy demand and hence machine orders will equal two i.e. orders have grown by 100% when demand has only increased by 10%. If next year demand increases by 10% again, one replacement machine plus one extra machine will be needed (approximately), and hence machine orders will remain at two, i.e. zero percent growth. Thus, for a continued constant rate of growth of machine orders, it is necessary for there to be a continued acceleration in the rate of growth of demand for output.

The rate of growth of machinery orders is therefore best compared with the acceleration of GNE. However, this cannot be the whole explanation as the crude theory does not account for capacity utilisation. If firms are operating at low levels of capacity, they will not respond to increased demand by ordering new machines but by increasing usage of existing spare capacity. Hence, both factors are needed to explain machinery orders and this is what is done in Charts 6 and 7. Thus where fluctuations in the machinery orders series cannot be explained by capacity utilisation in Chart 6 (e.g. 1974 Q1, 1975 Q1), they can be explained by the rate of acceleration of GNE series.

Investment cycles can then be easily explained in terms of small fluctuations in real GNE growth and capacity utilisation as well as the aforementioned movements in real interest rates. A slight upturn in real GNE growth stimulates investment, and hence consumption through a redistribution of national income from retained profits to wages. This further upturn in demand keeps capacity utilisation high and stimulates further investment. Real interest rates are forced up and consumption begins to drop away as financial assets become more attractive. The level of capacity utilisation drops, and investment begins to drop. Thus interest rates begin to turn down and the process continues until the level of real interest rates becomes low enough to stimulate consumption and fresh investment, and the cycle turns up.

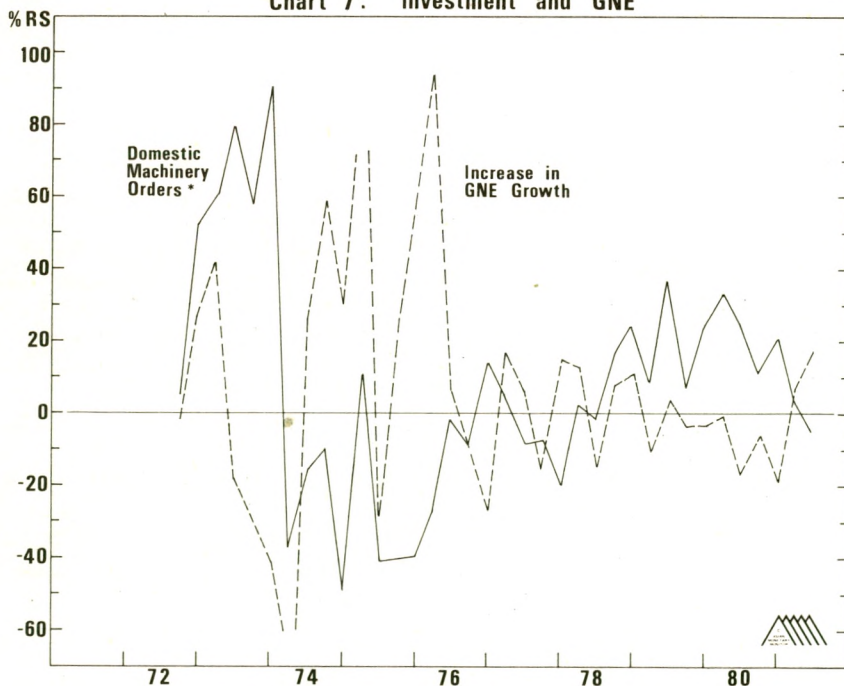
Briefly, the conclusion is that in a situation such as exists in Japan, with monetary growth firmly in control, domestic investment cycles can crowd out exports, or, if

JAPAN
Chart 6: Investment and Capacity Utilisation



*New orders for machinery from domestic manufacturing industry (inflation adjusted)
**Index of capacity utilisation for manufacturing industry

JAPAN
Chart 7: Investment and GNE



*New orders for machinery from domestic manufacturing industry (inflation adjusted)

exports are strong due to external factors, exports can crowd out investment and consumption through changes in real yields. This obviously will have important implications for capital goods producers and the profitability of those producers which rely mainly on the domestic market will follow the investment cycle. However, the profitability of those producers which have high export ratios need not be so cyclical. They can concentrate on the home market in times of a domestic investment boom and switch their attention to export markets during export booms. This is the fortunate position in which the leading machine tool companies find themselves, and their profits growth since 1977, as illustrated in Chart 1, bears witness to this.

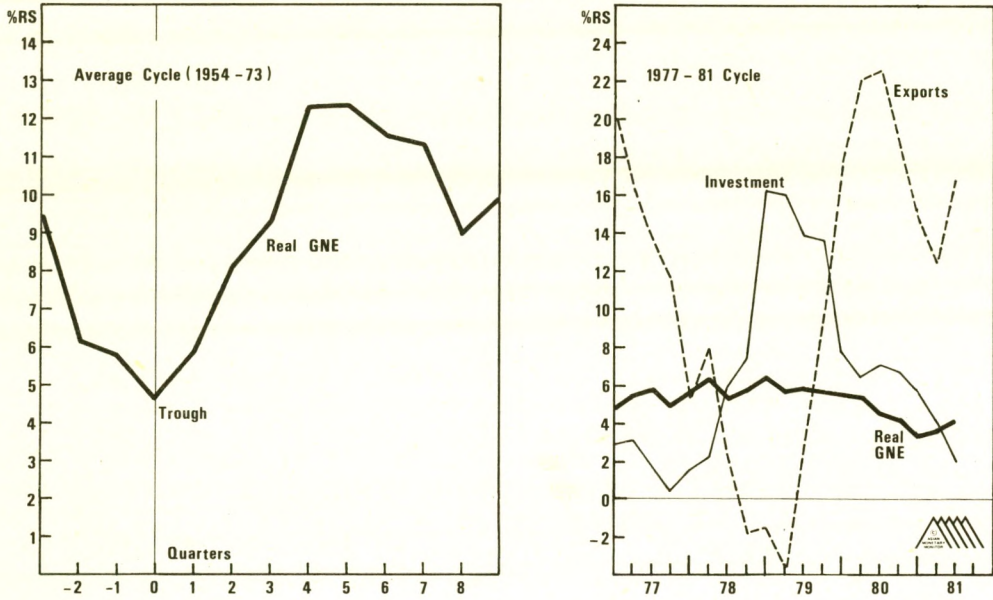
We have argued that there has been a change in the cyclical nature of the Japanese economy since 1976/77. The machine tool companies have certainly been able to take advantage of this change. However, this does not explain the extent of the profits growth evident in Chart 1. Indeed, it has been claimed that demand for machine tools is now non-cyclical in all markets. This claim is prompted by the phenomenal growth in orders for numerically controlled machine tools which is illustrated in Chart 9, a chart which compares the growth of deflated N.C. machine tool orders since 1974 with the growth of orders for non-N.C. machine tools since that date. The growth of N.C. machine tool orders since 1977 has been to a large degree non-cyclical in both foreign and domestic markets. Non-cyclical in the domestic market for N.C. machine tools has been mainly the result of a change in attitudes towards investment. Investment in N.C. tools has been in the form of retooling undertaken for productivity and profitability considerations, rather than the usual capacity utilisation and replacement investment considerations outlined earlier. Thus, the fact that investment in N.C. tools to replace outmoded equipment has become almost a necessity due to their greater efficiency than traditional machine tools has meant that domestic demand for the products of the leading machine tool companies has become much less dependent upon the determinants which guide the domestic investment cycle.

However, this growth of domestic demand for N.C. tools must be a finite process, and as the domestic diffusion of N.C. tools tends towards its saturation level, then the domestic growth pattern will tend back towards the pattern of the investment cycle. There is some evidence from the events of 1981 that this process has already begun. If this is the case then in the future the maintenance of a high level of profits growth will depend more crucially upon export demand.

FORECAST: In 1981, the yen has been relatively weak due to high US interest rates, and exports have been strong, 'crowding out' domestic investment and consumption. The downswing of the investment cycle has been prolonged by the continued weakness of the yen as the Bank of Japan has eased liquidity when the rest of the world has been tightening. However, with the US economy now moving deeper into recession

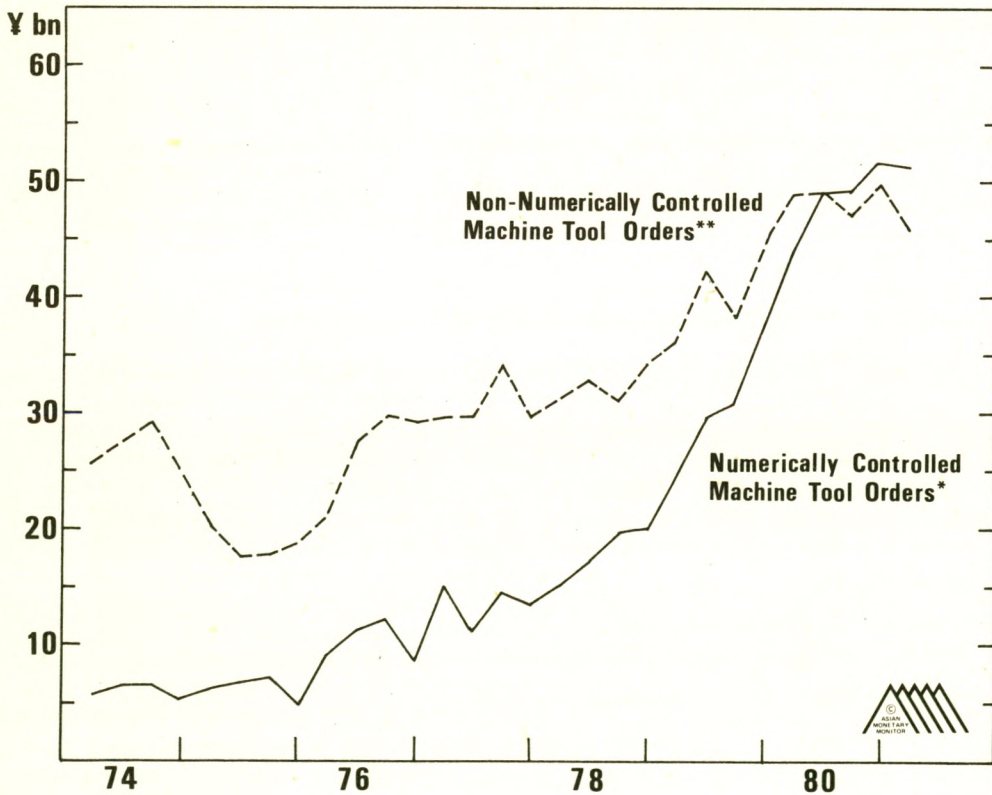
JAPAN

Chart 8 : The Business Cycle Before and After 1976



JAPAN

Chart 9 : Machine Tool Orders

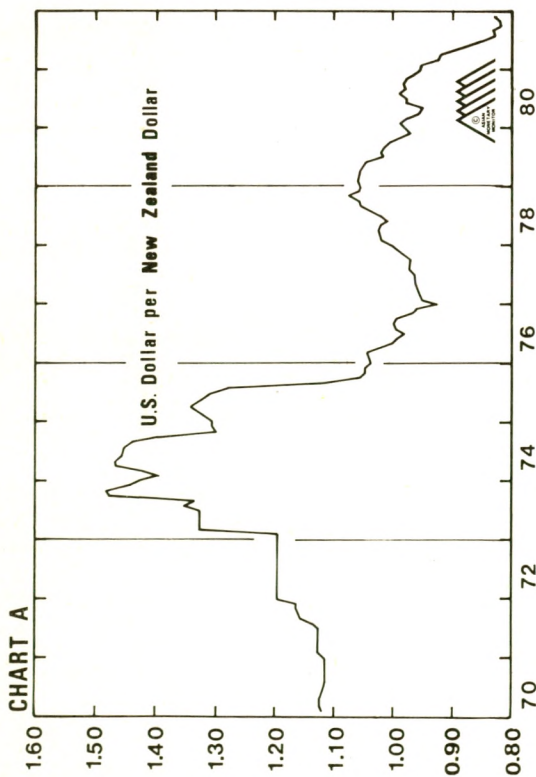


*Orders for numerically controlled machine tools (1972 prices)

**Orders for non-numerically controlled machine tools (1972 prices)

export demand will be weakening and Japanese real interest rates will begin to fall as US rates drop. Also, the easing of US rates has now led to some strengthening of the yen. Hence we should now begin to see a downturn in the external sector and an upturn in the domestic sector of the economy. Other things being equal, this suggests that 1981 should have been a good year for export-oriented capital goods producers, but a relatively poor year for those producers dependent more on domestic markets. The converse ought to be true in 1982 with machine tool companies being no exception. However, whereas the past domestic economic cycle was characterised by a strong investment cycle but a weaker, slightly lagging, consumption cycle, the factors that made for the strength of the investment boom (technological and rationalisation investment) are now not so noticeably present, and hence the next upturn will be characterised by a stronger consumption cycle and weaker investment cycle.

NEW ZEALAND DOLLAR



The New Zealand dollar should be recognised as a fundamentally weak currency. There is every reason to expect that its depreciation against the US dollar - which has exceeded 24% since the end of 1978 - will continue in the medium term unless there is a significant reversal in the authorities' economic policies.

The marked weakness in New Zealand's currency since the middle of 1973 stems from the Reserve Bank's excessively easy monetary policy. Double digit monetary growth for the major part of this period has led to persistently high rates of inflation. The last occasion that consumer price inflation dropped below the ten percent level was in the third quarter of 1973. Since then, inflation has averaged well over 14% on a yearly basis. This has been far in excess of the average inflation rate in the US during the same period, and has produced a steady erosion in the long term "equilibrium" value of the New Zealand dollar since 1975. This is illustrated in Chart D which indicates that in spite of the recent decline from US\$1.06 to US\$0.82, the New Zealand dollar may still be as much as 35% overvalued against its US counterpart.

During 1979 and 1980 there were some signs that the Reserve Bank was attempting to rectify the fundamental weakness of its currency.

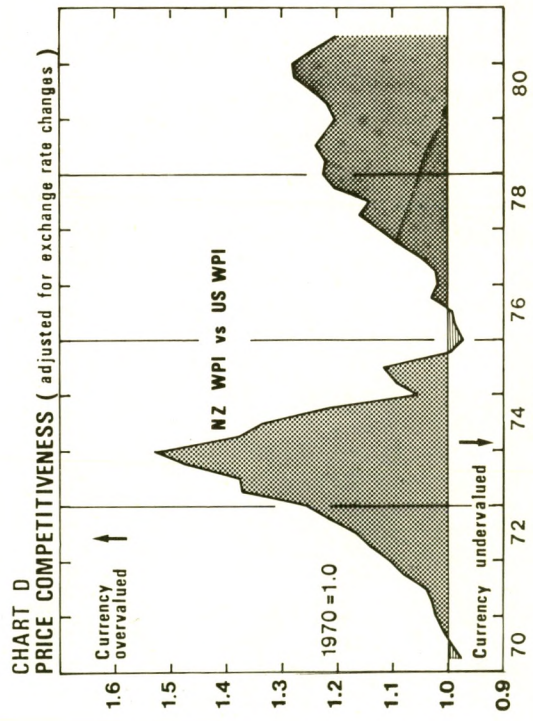
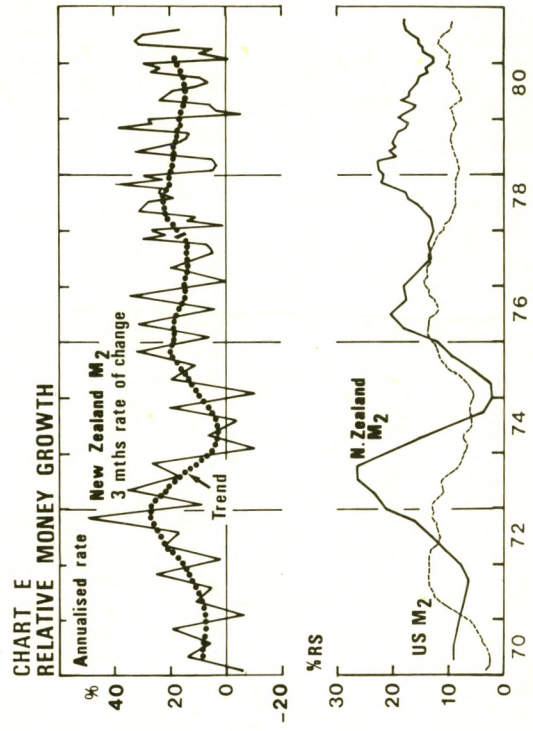
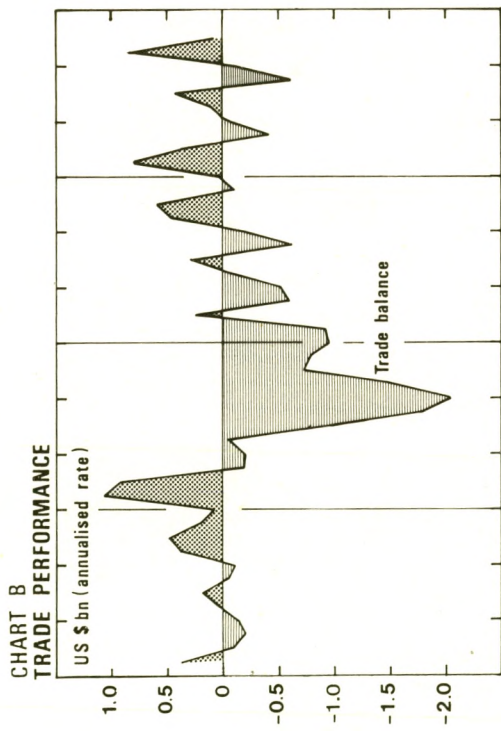
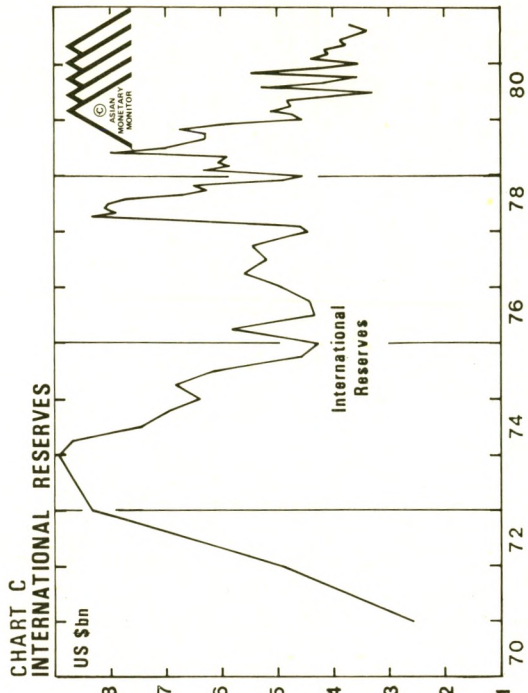
It raised the Official Discount Rate from 10½% in December 1978 to 14% by the end of 1980, and gradually brought the rate of growth of M3 down from 22% in the first quarter of 1979 to 12% in January 1981. This sustained slowdown in monetary growth, in turn, led to a mild drop in consumer price inflation, which has declined from 18.3% to 15.1% in the last eighteen months. However one of the costs of stricter monetary control has been slower growth in the domestic economy, where real incomes have been virtually stagnant in the last two years. At the start of this year the Reserve Bank evidently decided that the squeeze had gone far enough. It reduced its Discount Rate by 1%, and M3 growth has since accelerated, once again, to 16% year-on-year.

This easier stance on the part of the Reserve Bank is fundamentally bearish for the New Zealand dollar. Inflation may decline somewhat further, but the recent rise in monetary growth implies it is very unlikely to fall into line with inflation in the US. Thus the large imbalance in the "inflation adjusted" exchange rate which is depicted in Chart D will continue. With the Federal Reserve in the US attempting to follow an aggressively restrictive monetary policy, and New Zealand's international reserve position deteriorating, the Reserve Bank's lax monetary discipline will produce further weakness in the New Zealand dollar over the medium term.

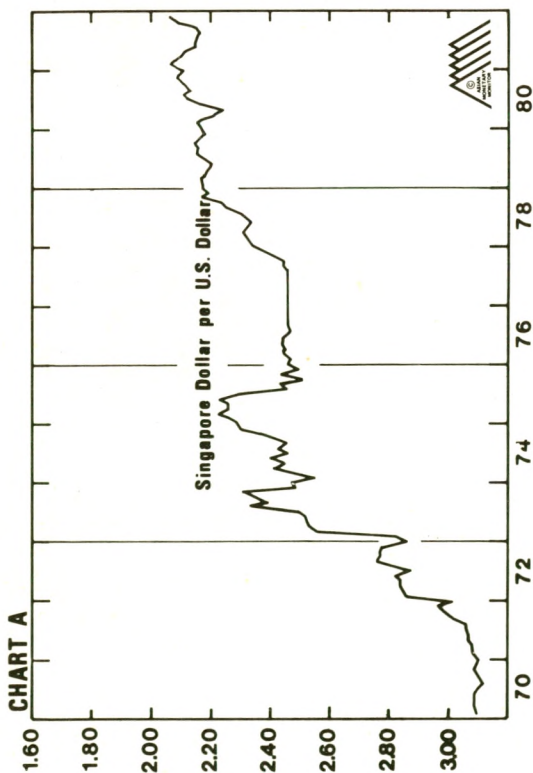
US\$/NZ\$	ACTUAL		FORECAST	
	1981 03	Oct.-Nov.	1982 01	02
	0.8105-0.8555	0.8137-0.8435	0.82-0.85	0.80-0.85
FORECAST A				
Actual Range				
FORECAST B				
			0.78-0.84	0.75-0.80

Forecast A assumes that US interest rates decline gradually into the first quarter of 1982 and that the Reserve Bank continues with its relaxed monetary policy.

Forecast B assumes that there is a further rise in US short interest rates during the first half of 1982.



RS: RATE OF CHANGE OVER SAME MONTH OF PREVIOUS YEAR



The Singapore dollar has continued firm against the US dollar, rising to its highest level this year at the end of October. The Singapore currency's appreciation against the US dollar has been interrupted on only two major occasions since the end of 1979. Both periods - the first quarter of 1980, and the second quarter of 1981 - were characterised by generalised strength in the US dollar - but overall the Singapore dollar has traded relatively steadily against the US currency. This, of course, primarily reflects the Monetary Authority of Singapore's policy of managing the Singapore dollar against a basket of other currencies. This has dampened the volatility of the S\$/US\$ exchange rate.

Although the Singapore dollar has remained firm during the last two years, its reputation as a strong currency looked to be in doubt towards the end of last year. At that time we witnessed an unparalleled surge in domestic monetary growth. In less than a year, M2 growth accelerated from 10% to over 30%. This excessive monetary growth threatened to undermine the fundamental strength of the Singapore dollar by exacerbating inflation and creating additional downward pressure in the trade deficit.

It is clear from Chart B that the second of these dangers has,

in fact, become a reality. Singapore's trade deficit will average close to US\$8 billion this year, a substantial deterioration over the US\$5 billion during 1980. Concern over the trend in inflation has also been justified. Although wholesale price inflation has declined substantially during the last year (down from 20% in the summer of 1980 to 3% in the year to August) as a result of falling import prices, consumer price inflation has accelerated from 5% to nearly 10% during the past six months. This is a direct result of excessive monetary growth in 1980.

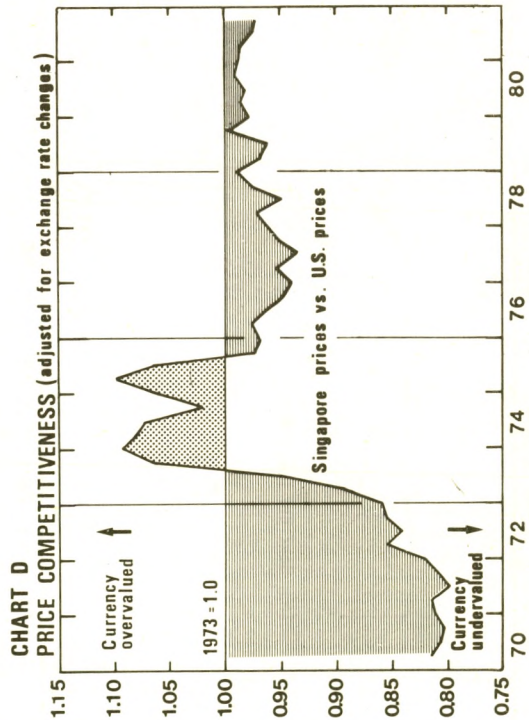
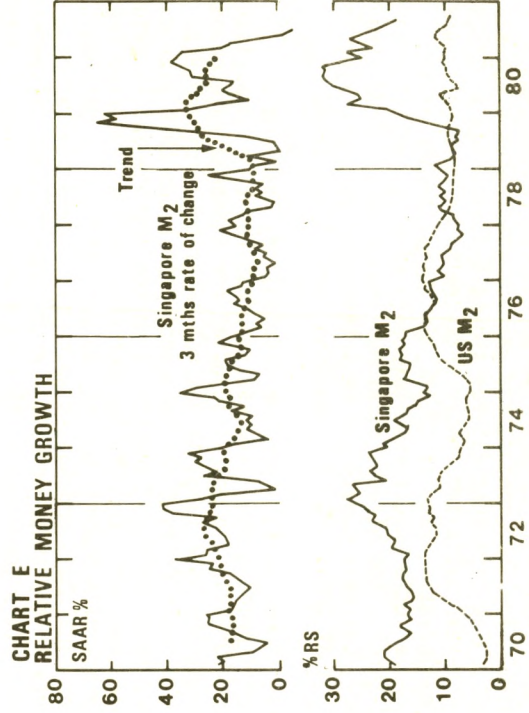
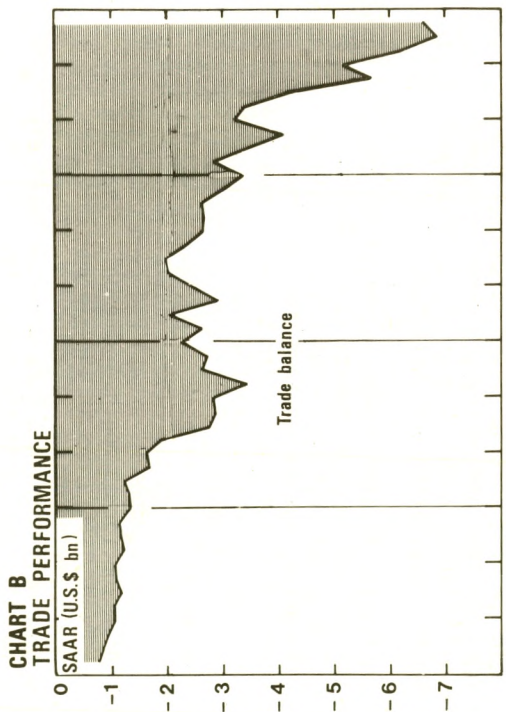
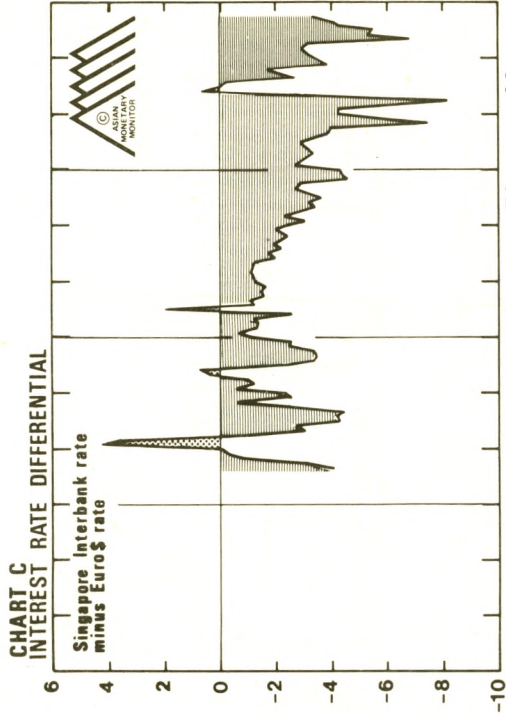
Typically we would expect the combination of a deteriorating trade account and rising inflation to prove bearish for the Singapore dollar. Similar circumstances provided the backdrop for weakness in the Singapore dollar during 1975. However a fundamental deterioration in the prospects for the Singapore dollar seems to have been averted. By deliberately maintaining the value of the Singapore dollar at a high level and by encouraging domestic interest rates to rise the M.A.S. has caused a sharp curtailment of monetary growth. With the recent rise in local prime lending rates to 15%, this trend is set to continue. M1 has also declined sharply, from 16% year-on-year in September 1980 to 5.1% in August. In due course the M.A.S.'s restrictive monetary policy will lead to a stabilisation in Singapore's trade account and lower inflation. This should prove bullish for the Singapore dollar in the longer term.

The medium term prospects for the Singapore currency really depend, once again, on the trend in US interest rates. The Singapore dollar will appreciate against the US dollar as US rates fall, but its appreciation is unlikely to match that of the Swiss franc or deutschemar

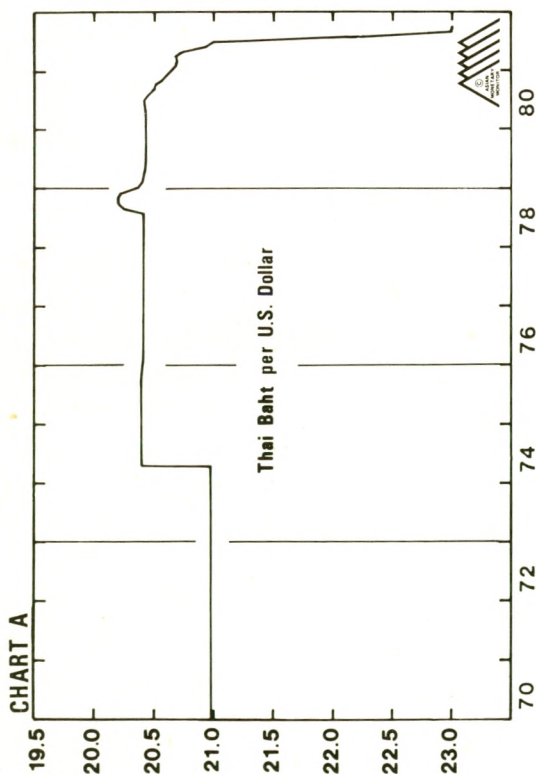
S\$/US\$	ACTUAL		FORECAST	
	1981 Q3	Oct.-Nov.	1982 Q1	Q2
FORECAST A				
Actual Range	2.110-2.185	2.013-2.115	2.04-2.10	1.95-2.08
FORECAST B			2.04-2.20	2.10-2.25

Forecast A assumes that US interest rates decline gradually into the first quarter of 1982, and that the M.A.S. continues with its restrictive monetary policy.

Forecast B assumes that there is a further rise in US short interest rates during the first half of 1982.



SAAR: SEASONALLY ADJUSTED AT ANNUAL RATE
RS: RATE OF CHANGE OVER SAME MONTH OF PREVIOUS YEAR



In July of this year the Thai Baht was devalued from 21.0 baht to the dollar to 23.0. In the last edition of AMM we suggested that this year the Thai economy has been undergoing a monetary squeeze and that this would help to reinforce the strength of the baht and prevent the need for further devaluations in the future.

At first sight, the figures for the broader aggregate of the money supply, M2, are not indicative of a squeeze at all in the first half of this year. M2 growth was still running at a rate of 20% by June, down only two percentage points from the last quarter of 1980. However, the more important figures are those for the narrower aggregate, M1. M1 growth was in single figures for most of the first half of the year, and down to an 8.8% year-on-year rate by June. It is true that, as it includes notes and coin in circulation, M1 does tend to move with the rate of inflation. However, it is significant that by June M1 growth had been below the rate of consumer price inflation for 18 months. The only other time this has occurred in over twenty years was in 1974-75 and this episode signalled an 18 month period of 4% inflation in 1975-76. We would expect M2 growth to move more into line with the level of M1 growth and inflation to fall further in the medium term.

By August consumer price inflation had been running at a rate of 11-12% for four months, the year-on-year rate in August being 11.1%. The September figures showed inflation up to 12.2% on a year-on-year basis and the recently released October figures indicate an inflation rate of 12.5%. In the aftermath of the devaluation we would expect some temporary rise in inflation in the short-term as the effects of higher import prices feed through the economy, but this should not be interpreted as signalling that inflation is at the start of a new long term rising trend.

Chart D shows that, after the devaluation, Thailand's international price competitiveness (as measured by a comparison of Thai and US wholesale prices adjusted for exchange rate changes) has been restored to a level it has not experienced since 1972. Although the trade deficit can be expected to widen this year due to a very poor first half performance, a marked improvement is evident in the third quarter. Exports in September were up 30% from the previous year, with imports up only 16%. This roughly matches the figures for June, July and August which all showed similar improvements in the trade deficit. With enhanced competitiveness and lower monetary growth rates this is a trend we expect to continue.

The Thai authorities are determined to maintain the current exchange rate to the dollar, and in the absence of a major strengthening of the dollar vis-a-vis other currencies we expect them to be able to achieve this aim.

Baht/US\$	ACTUAL			FORECAST	
	1981 Q3	Oct.-Nov.	1982 Q1	Q2	
FORECAST A			23.0	23.0	
Actual Range	23.0	23.0			
FORECAST B			23.5	23.5	

Forecast A The most likely exchange rate in the absence of some major political or external disruption.

Forecast B based on a simple projection of price competitiveness shown in Chart D i.e. the exchange rate required to bring US and local price levels into line.

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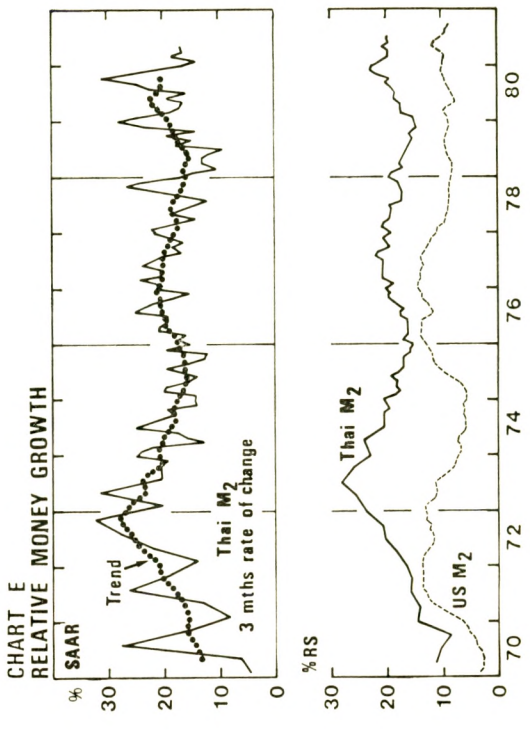
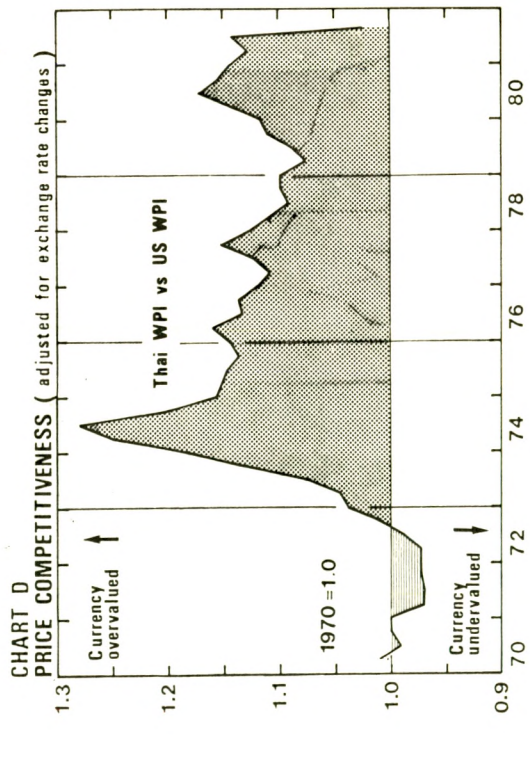
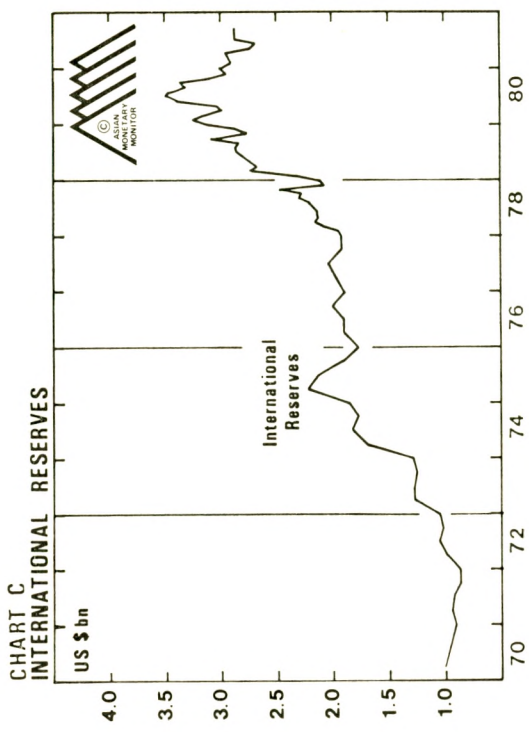
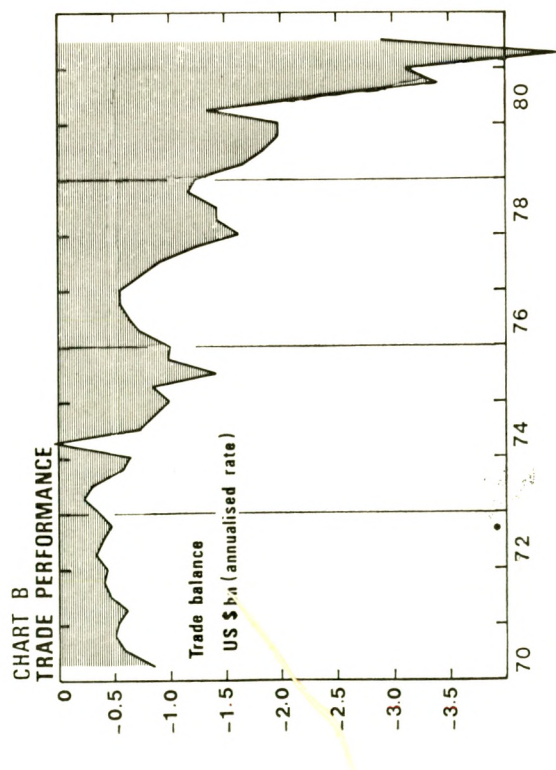
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